OCT 6 1980 Item 1035-A Y 4.B 85/2:C 74/3/981
1940

SECOND CONCURRENT RESOLUTION ON THE BUDGET—FISCAL YEAR 1981

66-1076 #703,7/403
Copies 579
12/30/80

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

JULY 22 AND 24, 1980
ECONOMIC BACKGROUND
JULY 23, 1980
CBO RE-ESTIMATES
PRESIDENT'S MID-YEAR BUDGET REVIEW

Budget 22 03

Printed for the use of the Committee on the Budget

SECOND CONCURRENT RESOLUTION ON THE BUDGET—FISCAL YEAR 1981

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

JULY 22 AND 24, 1980
ECONOMIC BACKGROUND
JULY 23, 1980
CBO RE-ESTIMATES
PRESIDENT'S MID-YEAR BUDGET REVIEW

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE
66-076 O WASHINGTON : 1980

COMMITTEE ON THE BUDGET

ERNEST F. HOLLINGS, South Carolina, *Chairman*

WARREN G. MAGNUSON, Washington	HENRY BELLMON, Oklahoma
LAWTON CHILES, Florida	PETE V. DOMENICI, New Mexico
JOSEPH R. BIDEN, Jr., Delaware	BOB PACKWOOD, Oregon
J. BENNETT JOHNSTON, Louisiana	WILLIAM L. ARMSTRONG, Colorado
JIM SASSER, Tennessee	NANCY LANDON KASSEBAUM, Kansas
GARY HART, Colorado	RUDY BOSCHWITZ, Minnesota
HOWARD M. METZENBAUM, Ohio	ORRIN G. HATCH, Utah
DONALD W. RIEGLE, Jr., Michigan	LARRY PRESSLER, South Dakota
DANIEL PATRICK MOYNIHAN, New York	
J. JAMES EXON, Nebraska	
GEORGE J. MITCHELL, Maine	

John T. McEvoy, *Staff Director*
Robert S. Boyd, *Minority Staff Director*
W. Thomas Foxwell, *Director of Publications*

CONTENTS

HEARING DAYS

Page

July 22, 1980 1

July 23, 1980 .... 101, 145

July 24, 1980 209

JULY 22, 1980

ECONOMIC BACKGROUND FOR THE SECOND CONCURRENT RESOLUTION FOR FISCAL YEAR 1981 1

Statements by Committee Members

Chairman Hollings 1, 56

Senator Bellmon 2

Senator Metzenbaum 4

Senator Exon 5

Senator Domenici 6

Senator Hatch 7

Witnesses

Evans, Michael K., president, Evans Economics, Inc 12

Prepared statement of Mr. Evans 16

Greenspan, Alan, president, Townsend-Greenspan & Co., Inc 70

Heller, Walter W., professor of economics, University of Minnesota 57

Prepared statement of Mr. Heller 65

Perry, George L., senior fellow, Brookings Institution 26

Santow, Leonard J., senior vice president and adviser to the board, J. Henry Schroder Bank and Trust Co., New York, N.Y 8

MORNING, JULY 23, 1980

ECONOMIC BACKGROUND FOR THE SECOND CONCURRENT RESOLUTION FOR FISCAL YEAR 1981 AND CBO RE-ESTIMATES 101

Statements by Committee Members

Chairman Hollings 101

Senator Bellmon 102

Senator Domenici 103

WITNESSES

Page
Rivlin, Alice M., Director, Congressional Budget Office 104

AFTERNOON, JULY 23, 1980

MID-YEAR REVIEW OF FISCAL YEAR 1981 BUDGET 145

STATEMENTS BY COMMITTEE MEMBERS

Chairman Hollings 145
Senator Bellmon 146

WITNESSES

McIntyre, Hon. James T., Jr., Director, Office of Management and Budget 160
Schultze, Hon. Charles L., Chairman, Council of Economic Advisers 147
  Prepared statement of Mr. Schultze 153

JULY 24, 1980

ECONOMIC BACKGROUND FOR THE SECOND CONCURRENT RESOLUTION FOR FISCAL YEAR 1981 209

STATEMENTS BY COMMITTEE MEMBERS

Chairman Hollings 209
Senator Bellmon 238

WITNESSES

Volcker, Hon. Paul A., Chairman, Board of Governors of the Federal Reserve System 210
  Prepared statement of Mr. Volcker 216

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Articles:

"$100 Billion is Found Approved but Unused in Public Works Plans," by John Herbers, *New York Times*, June 30, 1980 260

Letters:

To Chairman Hollings from OMB Director McIntyre, re Administration's budget estimates for the Strategic Petroleum Reserve 202

Reports:

President's Mid-Session Review of the Fiscal Year 1981 Budget 263
Midyear Monetary Policy Report to Congress, submitted by the Board of Governors of the Federal Reserve System 343

Statements:

Chamber of Commerce of the United States 390

INDEX 407

ECONOMIC BACKGROUND FOR THE SECOND CONCURRENT RESOLUTION FOR FISCAL YEAR 1981

TUESDAY, JULY 22, 1980

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:07 a.m., in room 6202, Dirksen Senate Office Building, Hon. Ernest F. Hollings (chairman of the committee) presiding.

Present: Senators Hollings, Chiles, Sasser, Metzenbaum, Exon, Mitchell, Bellmon, Domenici, and Hatch.

Staff present: John T. McEvoy, staff director; Susan J. Lepper, chief economist.

For the minority, Robert S. Boyd, staff director; Gail D. Shelp, senior economist.

Chairman HOLLINGS. Good morning, gentlemen. Mr. Evans will be along momentarily, and I think we can start with our opening statements and the introduction of the witnesses.

OPENING STATEMENT OF CHAIRMAN HOLLINGS

This morning the Senate Budget Committee begins its hearings on the second and binding budget resolution for 1981. We will be hearing from a number of distinguished witnesses unprecedented for a second budget Resolution, but, of course, these are unprecedented times.

UNEXPECTED DEEP RECESSION UNBALANCES BUDGET

The economic forecast on which we based our balanced first budget resolution has failed us. The latest economic forecasts now predict that unemployment and lost revenues will create a deficit of up to $60 billion in 1980 and about $29 billion in 1981 without any increased spending legislation on the part of the Congress.

These deficits result from a recession which has proved to be much deeper than the economists forecast last spring when we passed the first budget resolution. These deficits will occur even though the Senate just passed an unparalleled $6.4 billion reconciliation bill to reduce 1981 spending.

I must tell you it is very discouraging to work so hard to limit Federal spending only to have the bottom fall out of the economy and plunge us into deficit again.

MAJOR TAX REDUCTIONS FOR 1981 WOULD INCREASE DEFICIT

At the same time, many in Congress, in the public and on the campaign trail are urging major tax reductions for fiscal year 1981 which will add greatly to the deficit. I have not committed myself to any of these tax cut proposals, and I am not a member of the Senate Democratic group which has been working on one. I intend to approach the question of tax reduction with an open mind and with a great deal of restraint still aiming for spending discipline. I am not openminded about increased spending; I am opposed to it. The fact that an unexpectedly deep recession may unbalance the budget is not an excuse for a new round of spending. The undeniable gains we made this spring toward spending control should not be sacrificed in an orgy of antirecession spending.

Beginning next Monday, we will mark up the second budget resolution for 1981. Under the present Senate schedule, we will enact it before September 1. The hearings which begin today and continue through Thursday are the first act of that markup. What we learn here will be applied there in constructing the budget.

We will be hearing from Walter Heller and Alan Greenspan this afternoon, from Dr. Alice Rivlin tomorrow morning, from OMB Director James McIntyre and Chairman of the Council of Economic Advisers Charles Schultze tomorrow afternoon, and then on Thursday morning, we will be hearing from Federal Reserve Board Chairman Paul Volcker.

We are privileged to have with us this morning three outstanding economists who will be discussing the forecast, proposals for improvement in the economy, and the tax cut issue. Dr. Leonard Santow is the noted financial analyst of Schroder Bank; Dr. Michael Evans is president of Evans Economics, Inc., and recently completed a pioneer supply-side economic model; Dr. George Perry of the Brookings Institution is a specialist in the problems of unemployment and inflation.

At the conclusion of any other Budget Committee members' opening remarks, I will ask Drs. Santow, Perry and Evans to make their opening statements, and then the committee members can proceed with their questioning.

Senator Bellmon.

OPENING STATEMENT OF SENATOR BELLMON

Senator **Bellmon**. Mr. Chairman, I would like to read a fairly brief statement, and I appreciate the opportunity to do this.

I join the chairman in welcoming our distinguished witnesses, Dr. Evans, Dr. Perry, and Dr. Santow. They have all testified before this committee at times in the past, and we have found their advice to be extremely useful, and I hope that will be the case again here today.

I especially look forward to their observations this morning because so often in the past Congress has been confronted with difficult policy choices and we have sought guidance from the economic and financial community, sometimes without too much success. I hope today we wiil get very specific and helpful ideas as to the direction we should pursue. The dilemma this committee faces today is not one of alternative policy choices but rather, in my judgment, one of simple consistency.

ECONOMIC RECOVERY SOONER THAN PREDICTED BY FORECASTERS

This committee adopted a policy of fiscal restraint in our first budget resolution for fiscal year 1980 in an attempt to restrain the rise in inflation. Since that time, we have not only adhered to this policy, but have become more committed to its pursuit. I am at a loss as to how we can credibly reverse this policy after so brief, and not unexpected, a period of economic stress.

I do not share the consensus view that the economy is in a deep and prolonged recession, that unemployment will rise steeply in coming months, and that the recovery will be weak. On the contrary, I am of the opinion that the recovery will come sooner and be more brisk than most economic forecasts now predict.

My own view is that the economy was shocked into a brief but severe stall by the unprecedentedly high interest rates earlier this year. Now, interest rates are lower and the economy is clearly responding.

Already we have evidence of a recovery in the housing industry. Consumer confidence has turned up, and retail sales in June rose for the first time since January. Auto sales, which have been dismal to say the least, appear to be picking up. Production and inventory adjustments to lower sales have been unusually rapid. Even common stock prices, which were depressed, have now reached a 3-year high.

Indications of recovery should not be surprising. Since 1973, the economy has exhibited higher growth, higher inflation and, eventually, higher interest rates than economists generally expected.

USE OF MONETARY SHOCKS TO STEM INFLATION

During much of this period, Congress has focused fiscal policy, and I think mistakingly so, on increasing the rate of economic growth rather than stabilizing economic growth. Clearly, the momentum of the expansion and the accompanying inflation has resulted in several severe adjustments in monetary policy.

In fact, I find the present situation strikingly similar to 1973–74, when inflation rose to what was then considered an unprecedented peace-time high of 13 percent and monetary policy was tightened sharply. The shift in monetary policy sent the Federal funds rate to near 13 percent and long-term corporate bond rates to over 10 percent. We now consider these rates low in comparison to our recent experience. The dramatic actions by the Fed at the beginning of 1974 set the economy, which was already slowing, into a tailspin that was to last until April 1975, with tremendous costs in terms of lost output and jobs.

How did Congress react to this experience? After more than a year of declining production, the Congress enacted a tax cut as soon as inflation and interest rates appeared to be easing. This tax cut was enacted on the very eve of the economic recovery, March 19, 1975. Not only did fiscal policy tend to be stimulative after the recession, but the Federal Reserve accommodated the Congress efforts to pump up the economy.

Last October and also in March, the Fed found itself again chasing a runaway inflation rate, with disastrous results for both inflation and for interest rates. Just 3 months ago, inflation and interest rates reached near the 20 percent mark, 50 percent higher than at the peak of the last economic cycle.

MONETARY SHOCKS INCOMPATIBLE WITH LONG-TERM STABILITY

I believe that the monetary shocks by the Fed in recent years have been necessary. I do not believe, however, that such shocks are compatible with long term economic stability. I am deeply concerned that we again face a period when economic projections that suggest stimulus will prove misleading, and that we will again create the occasion for a hasty and ill-advised policy shift that we will later regret. I believe that the time has come for us to learn from past experience, to chart a steady course, and to give monetary policy, which is now very stimulative, a chance to work.

I hope that our witnesses today will address the problem of setting economy policy amid considerable uncertainties about the economic and the effect of policy shifts on the general sense of uncertainty in the economy.

In particular, I hope that our witnesses will assess the possibility that the economy may be stronger and inflation higher in coming months than we now anticipate. How should we in the Congress interpret the recent indications of recovery given the forecasts of continued recession through yearend?

I also hope that if our witnesses come to us with recommendations for stimulative actions, that they will also identify what it is in the economic outlook that has changed so significantly as to make such actions necessary now. I encourage each of our witnesses to be very specific about the goals they would hope fiscal policy would achieve with the policies that they may advocate.

Can the Congress credibly alter its policy of fiscal restraint given its commitment over the past year and a half? What will be the response on monetary policy and financial markets to a radical shift in fiscal policy and the large deficits spawned by tax reductions or failure to control spending?

I realize that the answers to these questions are not easy, and that the ultimate responsibility lies with the Congress. However, I would deeply appreciate any guidance that our witnesses can provide.

Chairman HOLLINGS. Senator Metzenbaum.

OPENING STATEMENT OF SENATOR METZENBAUM

Senator METZENBAUM. Mr. Chairman, as we commence this series of hearings, I would like to make a request with respect to the procedure, and it is not a major request, because it is followed in many other committees.

I have found that in the past we sat through Budget Committee hearings and various persons, outside witnesses as well as government witnesses, took a very lengthy document, stuck their head in it and started droning away and reading it. Actually, it was very difficult for many of us just to stay with them and to follow the point. And I am wondering whether or not we could not at least make the effort to suggest to our witnesses that they make an oral presentation and that they speak to us as to the thrust of their concerns and make their points in a period of maybe 10 or 12 minutes, or whatever the Chair decides is the appropriate time.

Their full statement would be included in the record, and then we would have more opportunity to question the witnesses on a leisurely basis and perhaps to better understand where they are going or where they are coming from.

I make that as a request, not as a formal matter. I think our hearings would be more purposeful under those circumstances.

Chairman HOLLINGS. That is a good suggestion, and generally, the witnesses like Dr. Perry, who appears regularly before many of the committees of Congress, have just, let us say, 10-minute statements. Others who have longer statements, we will ask them to summarize it, try to hold it within 5 or 10 minutes, and the entire statement would be included in the record. I think that would get us moving, as you indicate, into the questioning and into the presentation of exchange.

Jim, do you have anything?

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Mr. Chairman, we are back into our second concurrent budget resolution, and I share the concerns in the opening remarks of the chairman. I got back last night and picked up the paper and saw a $60 billion projected deficit after the work that we had done, and even $30 billion next year. I remembered, Mr. Chairman, that a year ago now we were sitting around this table and we were quite confident that we would have a balanced budget starting in October, and that if we could hold spending down, we would have a $55 billion surplus.

Now, if you take that $55 billion surplus that has evaporated and put the $30 billion deficit on top of that, we have lost $85 billion somewhere on the way to the first and second concurrent budget resolutions.

I must tell you that I, as one member of this committee, am tremendously frustrated about whether or not we are in a situation where Federal spending and deficits are so far out of control that maybe we cannot do anything about it. If we are in that situation, then I would suggest that we, as elected officials, and the experts like these three distinguished gentlemen that we have this morning that are appearing before us once again, may have to take a whole new look at where we are going in this situation, if we are ever going to have a chance to get a hold on inflation, which worries me very, very much, as we proceed to a sound—hopefully, a sound economic policy for the future.

So I am delighted to have these men here, and I think the suggestions that have been made by my friend from Ohio are well taken, because we sure need some help, and we appreciate you gentlemen coming here this morning to give us that help.

INCREASED OUTLAYS/REDUCED REVENUES INCREASE DEFICIT

Chairman HOLLINGS. I thank you, Senator, and I will ask the staff to make certain that the members all receive—I have not received that little booklet with the new Congressional Budget Office re-estimates. We all have the Mid-Session Review from the administration.[1]

---

[1] See p. 263.

We had assumed a $46.95 billion deficit for the fiscal year 1980 in which we are now presently engaged, and I wondered how in the world could that deficit jump up some $15, $16 billion since we left town. They tell me—and I hope there is a worksheet here for all the members; I will ask the staff for that 1980 budget worksheet showing the lower revenues—revenues dropped by $8.7 billion. These are very significant to us as the working members who sat, for example, in the conference committee day in and day out fussing about $100 million and you find out that you are $8.7 billion lower in revenues. The spending—higher outlays due to sharper recession—is up by $4.5 billion, and then there are some higher outlays based on the latest information on spending patterns. For example, the Defense Department is up some $1.1 billion; medicare payments is almost a billion; the urban transit payout rate is even faster, at some $600 million; the farm price supports, another $300 million; disaster, going out at the rate of $300 to $400 million more.

So if we look at that sheet, we as members will be getting into that argument—excuse me; let me yield to Senator Domenici. Did you have a statement?

OPENING STATEMENT OF SENATOR DOMENICI

Senator Domenici. Mr. Chairman, I will put my statement in the record, if you would.

I generally share the concerns expressed by Senator Bellmon and the frustrations expressed by my good friend from Nebraska. I really find it quite difficult to understand how things jumped around as fast as they have. But I am firmly convinced, Mr. Chairman, that we started out on a notion of fiscal restraint in order to affect inflation, and my thinking tells me that that is still a prudent course, and I do not know why we ought to change it dramatically. On the other hand, it seems that, in terms of the balanced budget itself, it has changed dramatically without us having much to say about it.

I am really more concerned this time than I have been in the last 5 years as to whether or not the forecasts for 1981 are anywhere near accurate. I mean, these deficit figures we are using are assuming not only that we are in a recession, but that we have not bottomed out yet and that it is going to go on for a long, long time. There are certainly some signs to the contrary. But I am very interested in receiving some assistance with reference to that aspect, because that clearly influences the outcome of the policy set in our First Concurrent Resolution.

I thank the Chairman.

Prepared Statement of Senator Domenici

We begin our hearings on the Second Concurrent Budget Resolution in troubled economic times. We have experienced a rapid drop in the Gross National Product growth rate; unemployment is up; inflation still remains in the double-digit range. We have the worst economic slowdown since the end of World War II.

Yet, I see some signs that we may at this moment be in the worst of the downturn. The technical signs that Senator Bellmon mentioned in his opening statement are encouraging—increased consumer confidence, an upturn in retail sales, some improvement in auto sales, increased building permits, declining interest rates, and improved stock prices.

CONTINUE FEDERAL SPENDING RESTRAINT

But, even more encouraging to me is that the American people seem determined to ride out this recession and embark on a new period of steady economic growth, with low inflation. This understanding on the part of most citizens that inflation still poses the most serious threat to our domestic economy means that we can continue to adhere to this Committee's year-long emphasis on restraint in Federal spending.

I have been on this committee as long as most members here. I can remember the times when we have relied on new economic forecasts of doom and gloom in order to justify new public works spending or other "pumping-priming" programs. Inevitably, the effects of such spending came after the recovery had begun and the net result was higher inflation than we otherwise would have suffered and not much improvement in employment. We must avoid that unfortunate scenario this time around.

FORECASTING CREDIBILITY CLOUDED BY RECORD OF INACCURACY

I will listen carefully today as our economist-witnesses at both the morning and afternoon sessions explain what they believe will happen in 1981. But, I must admit that I will take their forcasts with grain of salt. One of the real failings of our fiscal policy in the past has been our unwillingness to adopt a policy and stick with it for any length of time.

Our present policy, one which the Committee has fought for during the past 5 months, has been to battle inflation, which has reached an underlying rate of almost 10 percent in the eyes of some eminent economists. I believe we must continue that emphasis and that policy. We cannot change our policy with evey new forecast, especially given the extraodinarily bad track record of forecasters during the past 5 years. Indeed, it is this very clear record of inaccuracy that makes me suspicious of new forecasts that would indicate that fiscal stimulus is needed right now. I don't think we can abandon our policy just because the forecasters have changed their minds.

If we err on the side of stimulus, and economy proves more resilient than the forecasters predict, as has often happened in recent years, what risks will we run? We will risk inflation soaring from a base much higher than the base from which it took off 6 months ago. We will risk further deterioration of the dollar overseas? We will risk more unemployment and more loss of confidence in our economic system.

On the other hand, the risks of erring on the side of steadfastness seem much less. If we stimulate a bit to little, we will still see the automatic stabilizers in our system take hold and keep the plight of the unemployed reasonable bearable, at least in the short term. We may risk another one-tenth of a point in unemployment, but we may be able to wring four or five points of inflation out of the base inflation rate. And, a policy of restratint will being certainty to the economy and strength to the dollar.

All in all, a prudent policymaker would choose that course that offers the least risks to the citizens and that policy, in my judgment, should be to restrain Federal spending as part of our anti-inflation battle. To do otherwise is to put all of our eggs in a basket that may very well have no bottom and no future.

I hope that our witnesses today will assess just what odds they see of this recession continuing at its present pace, and when they believe the recovery will occur, if it has not already started. And, I hope they will share the kind of fudamental cost-benefit analysis with us that I believe is necessary when we choose between policies.

Chairman **Hollings**. Senator Hatch.

OPENING STATEMENT OF SENATOR HATCH

Senator **Hatch**. Thank you, Mr. Chairman. I really have no comments to make. I am interested in what these gentlemen have to say today, and I hope they will cover some of the concerns that have been expressed by our colleague from Nebraska, the chairman and ranking minority member and, of course, Senator Domenici.

I think we have what appears to be a runaway situation with no real solutions under present circumstances. I would be very interested in suggestions as to what we might do, in terms of monetary and fiscal policy, to turn this around or whether we are just doomed to have runaway deficits and runaway inflation for the 1980's and maybe beyond. So I will be very interested in listening to the testimony today.

Thank you.

Chairman HOLLINGS. Very good.

Dr. Santow, we will start with you. I will ask all the witnesses if you can summarize. If we could try to hold to sort of 10 minutes a piece, or so—no real rule, but we want to get in and be able to ask the questions and have this explained to us.

STATEMENT OF LEONARD J. SANTOW, SENIOR VICE PRESIDENT AND ADVISER TO THE BOARD, J. HENRY SCHRODER BANK AND TRUST CO., NEW YORK, N.Y.

Dr. SANTOW. The recession is likely to reach bottom in the fourth quarter of 1980. The recovery in the first half of 1981, however, will be modest with all areas not participating in the advance. The second half of 1981 will have a more meaningful and broadly based recovery, although the rate of growth will still not be especially large.

The economy during 1982 should be better than 1981 across the board. The degree of improvement, however, is still an open question. Much will depend upon the tax reduction legislation and the savings inducements that are passed by Congress in 1981. In order to have a major economic improvement in 1982, plant and equipment outlays must be a primary driving force, and the only way it can be such a force is through legislative inducements. Plant and equipment never had a major boom in the last cycle, and there are many businesses poised to spend. Consumers, however, carried the last economic recovery, which lasted an unusually long period of almost 5 years, and they are unlikely to be in a position to lead a major recovery in 1981 or possibly even in 1982.

Simply put, the United States could see a major boom in plant and equipment spending develop in the 1982–83 period, but it can only happen if the legislative groundwork is laid during 1981. It is this type of recovery that is needed, because it would increase productivity, limit inflation, and add longevity and balance to the next business upswing. If there is an attempt to have the consumers lead the next business advance, the chances of the recovery being aborted are considerable.

The main difference between the business forecasts of economists seems to be more in timing than in pattern or degree. The optimists see the economy reaching a bottom in the fourth quarter of 1980 and beginning its recovery in the first quarter of 1981. The pessimists do not see the bottom until the middle of 1981, with the recovery then commencing. In almost all cases, estimates show a modest recovery for at least a year after the bottom is reached. My forecast would seem to stand more with the optimists than with the pessimists.

The specific pattern that I foresee is as follows: Real GNP will decline about 5 percent on an annual basis in the current quarter, decline about 1 percent in the fourth quarter, and rise about 1 or 2 percent in the first half of 1981. The GNP deflator will increase by about 9.5 percent in the third quarter, 9 percent in the fourth quarter, and between 8 and 9 percent in the first half of 1981.

Unemployment in this cycle will reach a peak of about 9 percent late this year, but will be slow in declining throughout 1981. By the end of 1981, unemployment could still be hovering at about 8 percent. In 1982, there could be a major improvement in unemployment, 1.5 percent or more, if a boom in plant and equipment should develop.

THE BUDGET

Turning to the budget, for the current fiscal year receipts should be about $520 billion, expenditures about $580 billion, and the deficit should be about $60 billion. For fiscal 1981, the numbers appear to be receipts of $585 billion, expenditures of approximately $635 billion, and a deficit of $50 billion.

The deficit for fiscal 1981 assumes a $30 billion tax reduction passed next year and effective July 1, 1981, with part of the package retroactive to early in the year. This is my best political guess.

There has never been a chance that the budget for fiscal 1981 would be in balance, let alone a surplus. While there has been a deterioration in the budget numbers since May, a deterioration should have been expected. Two possibilities exist: Either the administration has been naive in its estimates or just not very competent in analyzing the data. Unfortunately, the same is true of Congress, which has recently passed a balanced budget resolution when not the slightest chance of such a happening exists.

GOVERNMENT INABILITY TO BALANCE BUDGET

How can the Congressional Budget Committee develop credibility and power when its numbers are so far from the mark? It is your responsibility on this committee to point out at the earliest possible time the true story on the budget and any changes that appear to be occurring.

The inability of Government, after almost 5 years of economic recovery, to balance the budget is fiscal irresponsibility. The smallest deficit for this cycle was $27 billion last fiscal year, which means that the numbers rise from that base propelled by a softening economy. This situation obviously cuts back on fiscal flexibility, especially if you are trying to help an ailing economy.

Neither the administration nor the Congress have true longrun fiscal programs or game plans. May I suggest one: At least 1 year in every business cycle the budget should be balanced just to prove it can be done. The reason is not so much economics as it is to indicate to the American people and to the world that we can run a fiscally responsible Government.

Until we have attained the first balanced budget year, the growth in spending will be curtailed. One simple way to achieve such a program would be to place a percentage growth ceiling on expenditures for fiscal 1981 of, say, 9 percent and cut the growth ceiling by 1 percent each year until a balanced budget year is achieved. After that, the annual percentage growth ceilings would be determined by economic needs and the role of Government in those needs.

TAX REDUCTIONS FOR THE 1980'S

A longrun tax package for the decade of the 1980's needs to be passed. It needs to be given a special name and considerable notoriety. It should be economic growth oriented and not oriented toward cyclical stimulation. It should be simple, straightforward, easy to understand, and should be presented in a way that it is likely to be voted into law. I do not believe that in a period of less than 2 months, August and September of 1980, such a program can be properly devised, especially in the heat of an election battle. Therefore, the proper time to begin on this program is early in calendar 1981.

The tax reduction for the 1980's should be spread out over the decade. It should amount to about $100 billion in total, or about $10 billion per year. If the $100 billion package is passed next spring retroactive to the first of the year, even though the individual year reductions would be minor, which helps limit the Treasury receipts shortfall, individuals and companies will have the benefit of knowing there are nine more annual reductions to come.

There should be no reductions in this package in the form of individual income tax rates or corporate tax rates. These are not the most cost-effective methods for achieving longer run economic growth. Moreoever, the package should not be sold on the basis of tax reform, because it would open a pandora's box. Rather, it should be sold on the basis of a new approach to fiscal policy in order to stimulate economic growth.

BUSINESS TAX CUTS

Most of the $100 billion tax reduction would go to businesses since a boom is needed in plant and equipment outlays, hopefully as early as 1982. One cannot and should not expect consumers to carry the economy throughout the 1980's as they did in the last business cycle. If one wants unemployment to decline substantially in upcoming years, this is the most effective road to take.

Phased in during a period of 10 years would be such things as accelerated depreciation, increased investment tax credits and a slower implementation of environmental requirements. Each of these would not be passed across the board. Rather, each industry would be looked at separately and a meaningful combination of the three benefits would be implemented. The U.S. Government does not have the luxury of giving away tax receipts now unless there is a much larger tax payoff later.

Tax rates for individuals would not be changed in this package. However, what would be changed are the dollar levels at which the incremental tax rates apply. Thus, a package would be presented that would specifically spread out the progressivity each year for the 10-year period.

MONETARY POLICY

Turning to monetary policy, the Federal Reserve's tight money package of March 14 appears to have had a much greater adverse effect on economic activity than the monetary authorities expected. The two main areas where the potency of policy was underestimated were consumer credit control restrictions and the 6 to 9 percent loan growth ceilings for the banks.

While there is little doubt that the economy began to slip into a recession before the Fed's March package, the degree of recession has been considerably deeper because of the March package. However, before one becomes overly critical of the Fed's March package, it should be pointed out that inflation psychology has become very deep seated in this country, and possibly the only way to change that psychology is through some sort of shock treatment. I surely do not see such shock treatment forthcoming on the fiscal side.

Where the Fed's policies may be more vulnerable to criticism is that the authorities may have eased by too much, and too quickly, in the last several months. What the Fed has done in the last 3 months, which, in my judgment, was the greatest amount of easing ever done by the U.S. monetary authorities in such a short period, could have been spread out over 6 to 9 months. It is conceivable that the United States could wind up with the worst of all possible ends—a relatively deep recession without having inflicted any mortal wounds upon inflation.

Chairman HOLLINGS. We are not going to limit you; keep on going. You got my attention when you said I was either naive or incompetent. [Laughter.]

I have been listening ever since. [Laughter.]

You talk language I can understand. Go ahead.

ANNUAL GROWTH RATE TARGET FOR MONEY SUPPLY

Dr. SANTOW. From a technical point of view, the Fed's present approach to monetary policy is better than what existed before the October 1979 package and better than what was used from October 1979 into the spring of 1980. The current approach is basically monetarist in substance, but eclectic in implementation. Specifically, what the Fed seems to be doing is as follows:

It has an annual growth rate target for the money supply; the midpoint of that target range for M-1A has been 4.75 percent. In order to attain this growth in the money supply, the Fed has been trying to fine tune the growth of total reserves in general and nonborrowed reserves in particular.

Because the economy weakened so suddenly and sharply beginning in March, the money supply dropped in March and April and was flat in May. The Fed in the last several months has made a major attempt to get the money supply moving higher again. With the June increase, it now appears that the trend in the money supply is upward.

A 4.75 percent money supply growth rate would mean a 12-month advance of about $18 billion. In the first 6 months of the year, the advance was not much over $1 billion, so there is over $16 billion of growth to attain in a half-year. This would mean a need for about a $2.5 billion per month increase, or an advance of close to 8 percent each month for the rest of the year. Thus, the Fed's 2-month growth targets for the rest of the year are likely to be around 7 or 8 percent, and the authorities may have difficulty in the current economic climate in attaining such a target.

USE OF RESERVE GROWTH TO FINE TUNE MONEY SUPPLY

The Fed funds market has regained some importance in the last several months, but to nowhere near the degree that it had before the October 1979 package. The main difference is the current use of reserve growth to fine tune the money supply, rather than trying to use Fed funds rates in order to achieve money supply targets. This change is reflected in the fact that the Fed has an acceptable Fed funds range of about 1 percent, compared with as little as three-eighths of a percent in that earlier period, and is not aiming for a specific weekly average Fed funds rate as it did before.

There is a reason for having a meaningful band placed upon Fed funds rates, and that simply is the dollar's position in the foreign exchange market. Beginning early in the year, foreign central banks placed much greater emphasis upon interest rate differentials between countries, and some of these banks relied heavily upon such differentials to control the value of their currencies. This situation, while surely not causing the Fed to peg short rates to international considerations, does create a need for the Fed to closely monitor such differentials with a view that if the differentials put unacceptable pressure on the dollar, it should be considered in overall monetary policy deliberations.

While the period from October 1979 through the spring of 1980 was a purer monetarist approach than has ever been followed, there were some special reasons for this situation. It should be remembered that the October 1979 package was designed to achieve several things: a tightening of monetary policy, a movement toward a much more monetarist approach to policy, and an attempt to have the Fed funds market trade upon basic supply-demand considerations rather than the market's perception of where the Fed wanted funds to trade.

Given these multiple goals, and the uncertainties of how the new system would exactly work, or how much the Fed wanted to tighten, it would have been self-defeating for the Fed to control the funds rates. In my judgment, Fed techniques during that half-year required a special approach to policy which served a useful but limited purpose. We have now moved forward to a monetary policy that can be categorized as eclectic monetarism.

Chairman HOLLINGS. Thank you very much, Dr. Santow. Now, Dr. Evans.

STATEMENT OF MICHAEL K. EVANS, PRESIDENT, EVANS ECONOMICS, INC.

Dr. EVANS. Thank you very much, Mr. Chairman. I appreciate the opportunity to appear before the Senate Budget Committee again. In line with Senator Metzenbaum's suggestion, I will summarize my statement[1] briefly and spend the first few minutes discussing the economic outlook and then the implications of large budget deficits on fiscal policy.

ECONOMIC OUTLOOK FOR 1980 AND 1981

My view of the economy is that while we are in the midst of a severe recession, that the worst is over. The economy will recover, perhaps somewhat earlier than Dr. Santow has indicated, and I look for GNP to turn up in the fourth quarter and for the economy to advance rather rapidly during 1981, growing during the year at a rate of over 5 percent, which is about double the rate contained in the midyear congressional review.

---

[1] See p. 16.

I think that what we have seen in this particular cycle is a telescoping of time. What used to take months or even quarters to happen happened in a period of about 6 weeks. The economy completely and entirely collapsed after the mid-March Fed package, and the decline in GNP in April was an unprecedented rate; it was the sharpest decline that has ever happened to the economy, and this continued into early May. But after that period of 6 weeks, the economy has now more or less bottomed out. The housing industry has recovered; the auto industry is still sick, but it is improving; the unemployment rate will still rise further, but it is certainly not rising as fast; and while I expect that real GNP will decline about 4 percent in the third quarter, I think it will be up 1 to 2 percent in the fourth quarter.

UNEMPLOYMENT

Now, because the unemployment rate is usually somewhat of a lagging indicator, we do have to look for further increases in unemployment to 8.5 percent or perhaps a little higher by the end of the year. That is unavoidable, and I think that employment will probably grow slightly in the second half of the year, but the labor force will grow faster. So we do have to look to higher unemployment rates.

HOUSING STARTS

However, in 1981, I think could be a fairly robust year. The increases will come in housing and in capital spending; they will not come so much in consumption. But housing starts, which have now rebounded in June, should average about 1.5 million for the first half of 1981 and about 2 million for the second half of the year, because the demographic factors are very strong. The average person who is in the postwar baby boom is now of the age that he has to buy a house, and, in fact, the demand for housing, based on demographics, will be stronger in this 5-year period than of virtually any other time in the history of this country. Therefore, housing will be strong if money is available, and money is available. Mortgage rates will fluctuate around 12 percent; they probably will not get much lower than that, but the funds are once again available. So I think that we will have a very strong boom in that area.

CAPITAL SPENDING

Another area where I think that we will see some strength next year is capital spending. In fact, if it were not for the overreaction of the Fed in March, I think that plant and equipment spending would have been strong in 1980. We just have to look at a few of the figures that were available. The conference board publishes figures on appropriations for investment; they do this on a regular basis. Their figures at the beginning of 1980 show that capital spending appropriations were up 30 percent this year. That is a record; they have never been up that high.

Now, of course, what happened is that when recession hit and the bottom fell out, businesses canceled their plans, and as a result of that, capital spending in real terms will be down—everybody expects that. But the intentions were there. The Bureau of Economic Analysis also has a survey; that showed investment rising rapidly.

So I think that once we get the economy back on track, investment will be strong. We have so much replacement investment that needs to be done. We have a great deal of investment that has to be done related to energy, and I do not only mean oil and gas drilling, which is very strong, but energy-saving investment in plant and equipment.

Now, I think capital spending during the next year will be quite strong and will be the mainspring that will propel the economy forward. In fact, the only weak note for next year is the consumer, who is still worried about the effect of credit controls, worried about the effect of overextending debt, and also faced with the fact that his real income continues to decline. So consumers will spend a little bit more, maybe 2- to 3-percent in real terms, but will not be the mainspring of the boom.

INFLATION

Unfortunately, we are going to have to face the fact that inflation is not going to go away, and the estimate of inflation for next year, I think, is about 11 percent, which is about 1 percent higher than the midyear congressional review. Perhaps this difference is not large, but it does indicate that the chances of going to 8-percent inflation, which is the consensus forecast at the present, is almost out of the question.

In addition to the other problems of inflation that we have, we are going to have a substantial rise in food prices because of the drought, because of the fact that yields were depressed anyway, because the Fed in its wisdom chose not to lend farmers money in March, and therefore we will have sharply higher food prices, up at least 10-percent next year, as a result of these factors.

Now, these sorts of things are not really directly related to fiscal policy. They are a result of other factors, but we have to consider them. So the inflation outlook for next year, I would say, is not very good.

FISCAL POLICY AND BUDGET BALANCE

Now, how does all this tie in with the budget process, the deficit, and the optimal fiscal policy as I would define it? First of all, it is quite clear that we are going to have a large budget deficit next year. My estimate is for a $60 billion deficit instead of Dr. Santow's $55 billion, but the numbers are in the same ballpark.

The balanced budget was always a canard; I think that most people were aware of this. In fact, I remember testifying before this committee earlier and talking to Senator Bellmon privately and saying that the budget deficit for fiscal 1980 would be as much as $70 million. Well, that was not far off. We are not there yet; maybe we will get there in the next few months—I do not know—but it will certainly be $60 billion, if not more. And this is the sort of thing that happens as long as we continue to have Government spending grow faster than the rate of increase in GNP. During boom years, it looks like we are encroaching on the deficit; it looks like we are approaching a balanced budget. But this is not true, because really we are just setting the stages for higher inflation, tighter monetary policy and a recession, which brings us right back to where we were in the first place.

So we will have a $60 billion budget deficit next year, and, in fact, under current policies, business as usual, economics as usual, politics as usual, we are not going to have a balanced budget anytime in the next business cycle either.

FEDERAL SPENDING EXCEEDS GROWTH OF GNP

Now, of course, this does not have to be an absolute certainty. There are plenty of things that we can do to change the economy. One area, of course, is the level of Government spending. The ratio of Federal Government spending to GNP has been increasing over the last 25 years, but especially over the last 4 years. This ratio continues to rise; it will average 23.6 percent this year, and Government spending, according to the official budget estimates, will rise about 14 percent next year, far higher than the rate of growth in GNP.

Now, I realize that nobody likes to cut budgets, that it is not a very politically popular thing to do, but it stands to reason, at least in my opinion, that if we keep on having Government spending rising faster than GNP, we are unlikely to reach a balanced budget by that route.

IMPACT OF TAX CUT ON DEFICIT

Now, as far as the $60 billion deficit goes, that does include a $30 billion tax cut which will be passed, as Dr. Santow said, early in the year retroactive to January 1. However, if the tax cut were not passed, this does not mean that the deficit would diminish by the full amount, because the economy would grow at a slower rate and therefore revenues would lag. So even if we had no tax cut, the deficit for fiscal 1981 would be approximately $45 billion. In fact, these are conservative estimates. I should point out that if things go wrong, if my relatively optimistic view of the economy is not correct, if the entitlement programs are much larger than we expect, the deficit could rise to as much as $100 billion. That is not my forecast, but it is not out of the question, just as a $60 billion deficit, unfortunately, was not out of the question this year.

INCREASE SHARE OF RESOURCES FOR INVESTMENT

Now, in attacking the budget deficit, I would like to stress at least my views and beliefs that all deficits are not created equal. I think we need to look at more than simply the deficit number. For example, suppose we had two options, one in which, let us say, the Government budget was $800 billion and it was balanced, and a second option where the budget was $400 billion but ran a $50 billion deficit. I would have absolutely no hesitation in saying that the $800 billion balanced budget is more inflationary, because in a number of studies that we have done, the correlation is not between inflation and the size of the deficit, but between inflation and the size of the public sector itself and, in the more general terms, between inflation and the investment ratio, the proportion of resources which are spent on investment.

So if we are going to get the economy under control and if we are going to push for balanced, noninflationary growth, the only way that I know how to do it is to increase the proportion of resources that go toward investment. And for that reason, I think that we need a tax cut next year which targets on savings and investment, which does not do anything for consumption right away, although it will do later, as a rising tide lifts all boats.

TAX CUT FOR SAVINGS AND INVESTMENT

The tax package, therefore, that I propose is one which would accomplish the following things: First of all, I would switch depreciation over to a replacement cost basis instead of a historical cost basis, so that when inflation rises, depreciation allowances rise, thereby permitting firms to have the cash flow necessary to replace their investment at market prices. The second thing I would do is to cut the corporate tax rate from 46 percent to 40 percent. The third thing I would do to encourage personal savings is to increase the exemption on interest and dividend income to $1,500 per person. And the fourth thing I would do is to restructure the capital gains tax, so that someone who is an investor and puts venture capital into a new firm and holds onto the shares of that firm for 5 years or more would pay no capital gains taxes.

Now, this package, which would cost between $30 and $40 billion a year, would, in my opinion, be capable of diverting enough resources to investment so that we could get the inflation rate down to 6 percent by 1985. I would stress that this does not happen overnight. In fact, for the first 2 years, we would see a very small change in inflation. In fact, for 1981 and 1982, the rate of inflation is not going to be influenced that much by the size of the budget deficit. But as we get into 1983, as we again approach full employment and full capacity, we have a very stark choice: We can have business as usual, in which case the inflation rate rises and reaches peaks exceeding those that we have just come from, or we can shift resources into investment and have a gradual decline in the rate of inflation to 6-percent.

Mr. Chairman, thank you very much.

Chairman HOLLINGS. Thank you very much, Dr. Evans.

PREPARED STATEMENT OF MICHAEL K. EVANS, PRESIDENT, EVANS ECONOMICS, INC.

ECONOMIC OUTLOOK FOR 1980 AND 1981

Although the economy declined at a 9.1 percent annual rate in the second quarter, the worst of the recession is over. Real GNP will continue to drop in the third quarter but will turn around before the end of the year. 1981 will see renewed growth, although most of the strength will stem from the investment sector—housing, inventories, and capital spending. Growth during the latter half of 1981 and all of 1982 will be quite robust, but inflation will be a continuing problem. The highlights of the forecast are as follows:

Real GNP will decline 4 to 5 percent in 1980.3 but will rise 1 percent to 2 percent in 1980.4 and continue increasing for at least the next eight quarters. It is expected to rise 4 percent during the first half of 1981 and as much as 6 percent during the second half. On a yearly average basis, real GNP will decline 1.3 percent this year, but will rise 2.0 percent next year. The peak-to-trough decline in the recession will be 3.5 percent, but this will be followed by a strong upturn.

UNEMPLOYMENT

The unemployment rate will rise to 8.2 percent next quarter and peak at 8.7 percent in 1980.4. It will then decline gradually during 1981 but will average 8.3 percent during the year.

Yet the pattern of unemployment will be somewhat different this time, since this recession is more regionalized than any other in the postwar period. Besides being hard hit by the decline in purchases of consumer durables and capital spending, the Midwest is decimated by the 30 percent decline in net farm income this year. Thus the "gloom-and-doom" belt from Pittsburgh to Chicago will bear the brunt of the current downturn. The Southeast, which has been relatively unharmed by previous recessions except in 1974–75, will also be fairly hard hit because of the decline in housing starts and consumer purchases of furniture and apparel.

As expected, the Sun Belt will suffer only slight increases in unemployment, with that rate remaining below 7 percent for both Florida and Texas. The West Coast will escape unscathed except for the closing of lumber mills in the Pacific Northwest area. The most pleasant surprise, from a relative point of view, will be New England, which traditionally has borne the brunt of previous recessions. Because of the preponderance of high technology and defense-related firms, unemployment in New England should be well below the national average and remain in the 7–8 percent range.

UPTURN SEEN FOR CREDIT-SENSITIVE SECTORS OF ECONOMY

It may be premature to claim that consumption and housing are already starting to move back into the positive column, but the fragmentary evidence which we do have all suggests that the credit-sensitive sectors of the economy—new car sales, purchases of other consumer durables, and housing—are again starting to peek above ground now that the storm has passed, and signs of revitalization are now being spotted. For example:

Housing starts rose strongly in June, following the upturn in permits in May. While the increase was not spectacular, neither do we think it was a fluke, and look for housing starts to continue rising in the second half of the year.

Scattered evidence from local markets indicates that sales of existing homes turned up in June, aided and abetted by the decline in mortgage rates to 12 percent and in some cases as low as 11½ percent.

Domestic new car sales are now slightly better than the May trough levels, and should rise from 5.3 million to 6 million by the end of this quarter and 7 million by the end of the year.

The Conference Board's index of consumer sentiment posted a 6 percent increase in the most recent survey.

The so-called leading indicators, which probably ought to be renamed the coincident indicators, declined much less sharply in May than April, and in June will show either a relatively small decline or possibly even increase.

Claims for unemployment insurance fell during most of June and have continued to diminish in July.

As a result, we expect both consumption of durables and housing starts to register gains in the third quarter, although consumption of nondurables will still continue to decline because of advancing food and fuel prices. However, total conumption next quarter will be down only $3 billion, compared to the $29 billion drop in the quarter just ending, and will rise some $10 billion in the fourth quarter.

VIGOROUS ECONOMIC RECOVERY PROJECTED FOR 1982

Indeed, we think that the fourth quarter should result in a return to normalcy in the important consumer and housing sectors of the economy. Mortgage and credit markets have already stabilized, but most consumers are still very wary about purchasing goods on credit; by the fourth quarter we expect that at least some of this reticence will have disappeared. Housing starts should rise to 1.3 million units for the fourth quarter and reach a seasonally adjusted annual rate of 1.4 million by the end of the year as builders find that credit supplies are adequate and mortgage rates fairly stable within a band of 11 percent to 12 percent. Thus the stage should be set for a recovery of undeniable vigor next year, with all major sectors of the economy except net exports participating in this rise. The most important factors which will lead to this solid upturn are the following:

1. The housing boom, fueled by demographic factors.
2. Continued large increases in defense spending, particularly if Governor Reagan is elected President.
3. An unusually quick turnaround in capital spending, representing the incipient strength that was about to be shown in 1980—witness the upward revision of first

quarter investment plans and the 30 percent increase in appropriations tallied by the Conference Board before the economy collapsed.

4. The bounceback from what has become a 3½ percent rather than a 2⅓ percent decline from peak to trough particularly in inventories.

HOUSING STARTS

The major driving force behind strong housing demand is unquestionably demographic factors, since the postwar baby boom is not approaching the age where most of its members are buying a house for the first time. Previous housing demand has been attenuated by the fact that many individuals in their 20's postponed the decision to form a separate household unit for a few additional years. Now, however, they have belatedly decided to start families—a facet of society which is also noticeable in the upturn, after years of decline, of the birth rate. Thus the demand for 2.1 million starts per year is there; it is only a question of mortgage availability and the cost factor of purchasing and financing a house.

Mortgage money will be available in plentiful quantities, we predict, at least until the end of 1982. The cost, however, is a different story, a factor which looms large. We have suggested several ways in which the high initial cost of the monthly payments can be borne; basically these revolve around restructuring the financing during the lifetime of the mortgage so that the monthly payments can increase in tandem with higher income. Banks and Stanford University are also beginning to experiment with an equity kicker on residential mortgages, a method which they have long used on commercial properties.

Thus we estimate that housing starts will increase from 1.4 million units at the end of this year to 2.1 million during the second half of 1981. This will add $20 billion to real GNP during the course of 1981 and $10 billion on a yearly average basis.

DEFENSE SPENDING

The second factor, which has been all but ignored in the discussion of whether the economy will recover sharply next year, is defense spending. This used to be one of the major movers of the economy; it was primarily responsible for both the very rapid upturn in 1965 and 1966 with the subsequent inflation and the slowdown of the economy in 1970. While we are not predicting another armed conflagration in our standard forecast—although conflict with the Russians over the Middle East remains far too likely a scenario—we do look for another 18 percent increase in defense spending in 1981. Coming on top of a similar increase this year, the expansionary features of such a grain should be quite substantial.

CAPITAL SPENDING

Capital spending is somewhat of an enigma. The long-term factors which should result in a capital goods boom were gradually rounding into place when the recession struck with all its fury. We mentioned last month that the Conference Board series on appropriations were up 30 percent in the first quarter, which was an all-time record; to this we can now add the more modest but still surprising news that investment spending as measured by the BEA survey was revised up in the first quarter.

In another area, the capital gains tax cuts in late 1978 and the corporate income tax reduction 1979 would have had an important positive influence on capital spending had real growth not collapsed so suddenly. We had previously estimated that these tax cuts would add $6 billion to investment in 1980 and $12 billion in 1981.

BUSINESS INVESTMENT

The construction sector of fixed business investment was quite strong until recently and is still only expected to decline 8 percent in real terms from peak to trough. Part of this is due to oil and gas drilling and exploration. However, another contributing factor is the declining vacancy rate in commercial office buildings, as vacant office space in many central city locations is close to zero. The vacancy rate is also relatively low in industrial buildings, although this rate has turned up somewhat in the past few months. However, nonresidential construction reacts to change in output and unemployment with lags as long as five years, a greater span that we found for any other sector in the economy. Indeed, construction remained depressed from the 1975 recession until 1978, a much longer lag than any other components of investment.

In addition to all these positive factors, we expect a cut in depreciation lives effective at the beginning of the next year and further beneficial tax legislation in the early months of the Reagan Administration.

Summing up all these positive effects on investment, we still remain strongly convinced that this sector of the economy will provide unusual strength to the economy in 1981, and will provide the basis for a vigorous if not sensational upturn next year. While the 20 percent interest rates and credit crunch of March and early April were severe, they were short-lived enough not to influence long-term investment decisions. Indeed, even during the worst of the credit crunch, large construction projects were still being funded at long-term interest rates around 14 percent, so that this sector of the economy never suffered the dislocations which were visited on the housing sector.

INVENTORY INVESTMENT

Inventory investment will also decline more sharply than we anticipated two months ago in view of the severity of the recession. While this means a larger peak to trough decline—3½ percent compared to our earlier estimate of 2½ percent—it also means a somewhat stronger rebound during most of 1981. The inventory/sales ratio is likely to rise from its pre-recession average value of 1.40 to a peak of 1.54 in June, which means that this ratio will have to be scaled back by about 10 percent before inventories are once again in equilibrium. We estimate that this will occur over the next three quarters, with a total decline of some $26 billion in inventory investment current prices. However, the recovery next year will move inventory investment from −$6 billion in 1981.1 to +$9 billion in 1981.4. This swing does not affect the overall level of real GNP over the two-year period 1980–1981, but it does make the upturn a little more like the traditional fast starts from previous cyclical troughs which have been one of the enduring features of postwar business cycle history.

PERSONAL SAVINGS RATE

This discussion may seem a little bit like Hamlet without the Prince, since it does not yet include any comment about the consumer. However, our general position is that the consumer will be passive next year; in other words, the personal saving rate will remain approximately at its present level. During the latter three quarters of the year, we expect the saving rate to average 5.1 percent; the next year the expected figure is 5.2 percent. Hence consumption will increase by the rate of growth of real disposable income, which in turn depends primarily on employment strength and productivity growth.

I can think of several reasons why the measured personal saving rate might decline next year. First, the sharp increase in the stock market over the next 12 months should provide some capital gains, which could raise consumption both because of realized income and improved psychology. Second, monetization of assets, particularly homes, should provide at least a modest increment to consumption in 1981; even $10 billion would reduce the saving rate by ½ percent. Third, if the underground economy is indeed growing faster than its legitimate counterpart, this would imply a long-term downward secular trend in the personal saving rate. Fourth, the intensification of inflation later in the year should provide a modicum of forward buying. Fifth, credit usage has dropped precipitiously in recent months, as evidenced by the surprising $1.9 billion decline in May. If consumers return only part way to normal, the saving rate would fall from present levels.

As a matter of fact consumers are still scared from the recession and the sudden, almost malicious withdrawal of credit privileges, which is why we have the saving rate remaining steady next year. But if this forecast is in error, the risk would appear to be in the direction of higher consumption than we have predicted.

Thus, the problem really comes down to how fast employment is going to increase, which depends on the growth in investment and defense spending. If these categories, including inventory investment, increase $45 billion over the course of 1981, it would take an absolute downturn in consumer spending to keep the economy from a fairly vigorous recovery. The exogenous strength is coming from investment, and even if the consumer sits on his hands, the rest of the economy will rebound favorably.

INFLATION

Turning to the inflation picture, the decline in the rate of inflation to the 0.9 percent level in April and May, while a welcome respite from the 1.4 percent monthly gains posted during the first quarter, is generally viewed only as a steppingstone to much lower inflation in the second half of the year. Many economists expect this rate to diminish to 0.6 percent per month sometime in the third quarter, and the consensus estimate for inflation has recently been lowered from 10 percent to 8 percent, with the expectation that it will remain at this relatively low level for most of 1981 as well.

If this pattern did occur, it would be entirely consistent with previous historical evidence. For inflation has previously troughed not in the year of recession but in the first year of recovery, as can easily be seen by examining Table 1. The reasons for this trough in inflation are not hard to fathom. First, wage bargains are usually fairly modest, since they are based on last year's unemployment rate. Second, those workers who are still employed at the end of the recession are in general the more productive members of society, and once output turns up, productivity takes a marked cyclical advance. Third, the economy is still far away from bottlenecks and shortages, so capacity utilization can increase rapidly without causing any problems in production scheduling. Fourth, since the rest of the world economy tends to lag behind the U.S. performance by two to four quarters, they are either in recession or slow growth, thus relieving any pressures which might exist on prices in world commodity markets.

TABLE 1

[Increase in CPI, annual rates]

Recession dates	4 quarters before	During recession	4 quarters after	Next 4 quarters	Reduction due to recession
July 1953 to May 1954	0.5	0.3	−0.6	0.4	−1.1
August 1957 to April 1958	3.5	3.2	0.2	2.0	−3.3
April 1960 to February 1961	2.0	1.1	0.9	1.2	−1.1
December 1969 to November 1970	6.1	5.4	3.5	3.5	−2.6
August 1974 to March 1975	11.0	9.2	6.1	6.4	−4.9

Hence the consensus 1981 forecast for prices basically follows the pattern of changes in inflation after previous recessions. Prices declined from a 12.2 percent rate in 1974 to 7.0 percent in 1975 and 4.8 percent in 1976; these are slightly different from the figures in Table 1 because they are on a calendar year basis. However, the sharp decline in inflation had very little to do with the fiscal policy of that year or the previous one.

Inflation dipped to the 4.8 percent figure because of cyclical factors and the following exogenous factors:

Food prices rose only 0.6 percent during the year;

Energy prices, as measured by the price of gasoline and home heating oil, rose only 3.5 percent during the year; and

The cost of purchasing and financing a home, which up to that point rose about 2 percent to 3 percent faster than the overall rate of inflation, increased only 3.0 percent during the year. (All figures given above are December to December changes)

Compare this with what we predict will happen in 1981: Food prices will increase 8.7 percent during the year; Energy prices will rise almost 30 percent; and Home purchase prices will increase 15 percent.

Thus we emphatically disagree with the consensus forecast which calls for an 8 percent rate of inflation next year, and look for a rise to double-digit rates again in the near future. When this forecast was originally issued two months ago, it met with a great deal of skepticism. Since inflation has indeed abated since March, and since the consensus forecast for the rate of inflation has moved lower, it seems worthwhile to take another look at the pattern of consumer prices for the remainder of 1980 and 1981. The detailed estimates are shown in Table 2.

As long as energy prices are rising 30 percent per year, housing prices increase 15 percent per year, and food prices keep up with the general rate of inflation, we find no way that inflation can average less then 10 percent or 11 percent over the next 18 months. Indeed, several of these projections represent conservative estimates which could easily be higher were any disturbances to appear in the domestic or world economy.

TABLE 2

[Increases in CPI for 1980 and 1981]

Category	Weight	May	June	July	August	September	October	November	December	1981
Food and beverages	0.187	0.3	0.5	0.5	0.8	0.9	0.8	0.7	0.6	0.7
Housing	.450	1.5	1.0	.9	.9	.9	1.0	1.1	1.1	1.0
Rent	.060	.6	.6	.6	.6	.6	.6	.6	.6	.6
Home purchase	.104	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Financing, insurance and taxes	.109	2.5	1.2	.5	.5	.8	1.2	1.5	1.5	1.2
Maintenance and repairs	.036	.7	.8	.8	.8	.8	.8	.8	.8	.8
Fuels and other utilities	.065	2.0	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Household furniture and operation	.076	.5	.6	.6	.6	.6	.6	.6	.6	.6
Apparel and upkeep	.051	−.2	.0	.2	.4	.5	.5	.5	.5	.5
Transportation	.186	.3	.5	1.2	.9	1.1	1.3	1.3	1.3	1.3
Medical care	.048	.5	.7	1.0	.8	.8	.8	.8	.8	.8
Entertainment	.037	.6	.7	.7	.7	.7	.7	.7	.7	.7
Other goods and services	.041	.8	.7	.7	.7	.7	.7	.7	.7	.7
Total	1.000	.9	.7	.8	.8	.9	1.0	1.0	.9	.9

Note that in the areas of the economy not directly related to food, energy, or housing prices, we have assumed a very modest rate of inflation. Rent, maintenance and repairs, household furnishings and operation, apparel and upkeep, transportation except gasoline, medical care, entertainment, and other goods and services were predicted to rise an average of only 0.7 percent per month, or an annual rate of 8.7 percent per year. This is slightly higher than the consensus but certainly within shooting distance, and far different from the 11 percent rate which we are forecasting.

FOOD PRICES

The rise in food prices which we expect was actually totally avoidable. World grain supplies are adequate, and cattle prices were in the midst of a long decline from 1979 highs. Into this situation of relative tranquility, the Fed saw fit to step in and introduce chaos. Farmers used to be able to borrow money to buy feed, seed, and fertilizer at subsidized interest rates ranging from 6 percent to 8 percent. However, for reasons which are still not clear the Fed decided, at the height of the credit crunch, to compel farmers to pay the market rate of interest of 20 percent to 25 percent to borrow for these commodities. As a result, many farmers simply could not raise the needed cash and were forced to hold auctions to sell off their farm equipment and in some cases even their land. Some breeding herds were slaughtered, and applications of seed and fertilizer were reduced in many planting areas. Furthermore, drought conditions clearly will intensify the increase in food prices later this year.

While we can understand the Fed's desire to postpone purchases of consumer durables and housing until inflationary pressures had abated, it is perfectly obvious that the same logic does not apply to the farm sector. If the economy is overheating in March, a rational case can be made for causing the consumer to put off buying that car until June. However, if the farmer is planting his crop in April, postponing the application of seed and fertilizer until June simply does not have the same beneficial effect.

ENERGY PRICES

Energy prices are another area where price stability is just a memory of the past. We have had an oil glut of at least 1 million barrels per day all year, and yet OPEC prices have just advance another $2/bbl. on average. We estimate that the average price of imported oil will rise from $28/bbl. at the beginning of the year to $34/bbl. in the fourth quarter and $33/bbl. by the end of 1981. Even these figures are somewhat conservative given the games which OPEC has been playing over the past year and a half.

However, the biggest increases in energy prices are not due to the machinations of OPEC. Rather they are due to decontrol of domestic oil. Currently the average price for domestic oil is $20/bbl. By autumn of 1981, when deregulation has been completed, this price will almost by definition rise to the world price of $38/bbl. Thus domestic oil prices will rise 90 percent between now and then—in the space of little more than a year.

This is hardly to say that decontrol is a bad move; in the long run it will be helpful, although its value has been diluted by the imposition of the windfall profits tax without a plowback provision. However, the situation is so completely different from 1976 that it cries out to be recognized; and those who persist in pretending that inflation patterns will be the same in this recovery as they were last time appear to be very seriously missing the point.

HOUSING PRICES

The third major factor is the 15 percent increase in housing prices which we expect to occur for at least the next two years. Housing prices did not rise much faster than the rate of inflation in 1976 because there was no shortage of housing. However, the demographic situation has changed, and we will be entering next year with a shortage of approximately 1 million units.

Indeed, one of the most amazing aspects of the housing market in the past six months has been that housing prices have continued to advance in spite of a 30 percent decline in sales of existing homes and a 50 percent plunge in new housing starts. It does not take a wizard to figure out that when (a) mortage markets stabilize, (b) economic recovery begins in earnest, (c) individuals realize that housing prices will continue to outpace the rate of inflation, and (d) a shortage of 1 million units occurs because of demographic factors, the price of housing will increase at least as fast as it did during the most severe disruption of mortgage markets in the entire postwar period. In fact, a pretty good case could be made for an increase in housing prices well in excess of the 15 percent figure which we have included in the standard forecast.

Thus even under the relatively optimistic forecast that unit labor costs will increase only 8 percent in 1981, we are extremely hard pressed to derive any inflation forecast which is less than 10 percent for next year, with an estimate of 11 percent probably closer to the mark. The exogenous increases which have already been set in motion by restricting supply and adding to inflationary pressures can eventually be reduced with the proper mix of monetary and fiscal policy, but not in time to reduce inflation for next year.

FISCAL POLICY AND BUDGET BALANCE

The Federal budget deficit for fiscal year 1981 is estimated to be $60 billion, a far cry from the balanced budget figure submitted by the Cartrer Administration a few weeks ago. However, because of the high rate of unemployment, such a deficit will not be particularly stimulative. If we use the rule of thumb that each 1 percent increase in the unemployment rate raises the budget deficit by $25 billion, then we would find that the budget is in balance at a 6 percent unemployment rate, which is close to full employment for current demographic conditions.

However, all budget deficits are not created equal. We find very little correlation between the size of the budget deficit and the rate of inflation. Indeed, it is the size of the public sector, rather than the size of the deficit itself, which is more closely related to inflation. Given the choice between an $800 billion budget which was in balance and a $400 billion budget with a $50 billion dificit, we would have little hesitation in proclaiming that the $800 billion budget was the more inflationary of the two.

To put the matter another way, a $40 billion tax cut which consisted of a rebate, an earned income credit, or an offset against higher social security taxes would clearly be inflationary. Yet a $40 billion tax cut which stimulated personal and corporate saving while reducing consumption would actually reduce the rate of inflation.

FISCAL AND MONETARY POLICY

While the role of monetary policy cannot be disregarded, it must necessarily be considered in conjunction with the impetus of fiscal policy. Just as both blades of the scissors—demand and supply—must be used to determine the level of real output, inflation, and productivity, so too must both blades of the scissors—fiscal and monetary policy—be used to control and direct the economy. If Congress and the Administration insist on producing large budget deficits on a consistent basis, monetary policy is left with unpalatable options—it can either passively accept these deficits and permit the money supply to increase accordingly, or it can fail to supply additional monetary reserves, thereby plunging the economy into a recession. We cannot get monetary policy under control until we get fiscal policy under control.

This does not mean that monetary policy cannot be damaging during a period of permanent or even temporary fiscal restraint. During 1972, lulled by a false sense of stability caused by controls, the Fed expanded the money supply far beyond the needs of the economy, thereby setting the stage for the double-digit inflation which followed. However, this mistake is not likely to be repeated in the next few years. We believe that Mr. Volcker is doing a credible job considering the restraints he is facing. Yet when the economy starts to recover and inflation rates rise, we will once again face the same dilemma of expansion of the money supply beyond targeted levels or higher interest rates. This will not cause crowding out in 1981 and 1982, but will indeed lead to credit shortages in 1983 and later years—unless the tax cut diverts resources from consumption to investment, thereby providing the necessary funds for further expansion of the productive sector of the economy.

TAX CUTS

Because the economy is currently in a recession, a variety of tax cuts could be passed without having a material effect on inflation in the next two years. The differences begin to occur in 1983 and later years, when the economy once again approaches the region of full employment and full capacity. The course of the economy chosen now will influence what kind of inflation we can expect in 1983 and 1984.

This lesson has only recently—and sadly—been learned by the Carter Administration, whose economists thought it proper in early 1977 to disregard the possibility of increased inflation and concentrate solely on solving the problem of unemployment. While they were successful in their endeavor, we are still suffering the burden of increased inflation today. While the Carter Administration cannot be blamed for the second energy crisis, we estimate that their profligate fiscal policies added from 2 percent to 3 percent to the present rate of inflation.

Because the long-run effects of any tax cut are so much more important than the short-run effects, the exact timing and magnitude of the tax cut are not as important as the overall scope and direction. For example, if a $30 billion tax cut of the type we have described above were advanced or postposed six months, the effect on real GNP would be only that one-half percent, or less than 0.2 percent change in the unemployment rate.

The tax increase in fiscal year 1981 due to the imposition of the windfall profits tax, the boost in social security contributions, and the "bracket creep" effects of higher inflation amount to approximately $50 billion; it surely is not unreasonable to expect some offset to these increases. However, the greatest need at present is for supply-side tax cuts which stimulate productivity and investment, rather than those tax cuts which add only to demand. While the traditional demand-side tax cuts would have only a modest effect on inflation for the next two years, as we have already remarked above, they would accelerate the rate of inflation in 1983 and later years.

For these reasons I propose a $40 billion tax cut which would switch resources from consumption to saving and investment. This tax cut, which could reduce the rate of inflation to 6 percent of 1985, would be proposed of the following elements:

1. Valuation of depreciation allowances for new investment in replacement rather than historical costs. Original cost $5 billion per year, increasing to about $30 billion per year when all investment would be covered.
2. Reduction in the corporate income tax rate from 46 percent to 40 percent, at an annual cost of about $11 billion per year.
3. Increase in the exemption on interest and dividend income to $1,500 per person, at a cost of about $8 billion per year.
4. Restructure the capital gains tax laws so that anyone putting venture capital into a company and holding the stock for five years or more would not pay taxes. This restructuring would also include indexation of capital gains so that holders would not be taxed on increases due to inflation. The cost of this program is difficult to measure, but is under $3 billion per year.

What about a broad-based tax cut, such as the 10 percent across-the-board reduction recently proposed by Gov. Reagan and very similar if not identical to the first step of Kemp-Roth? Such a tax cut would be moderately inflationary if it were not accompanied by offsetting reductions in government spending from the 14 percent increase currently expected for fiscal year 1981. The increases would not be horrendous; a 10 percent reduction in personal income taxes for each of three years would raise the rate of inflation by about 2 percent after five years. If these tax cuts were accompanied by offsetting reductions in government spending of the same amount, the rate of inflation would be about 2 percent lower after five years.

TABLE 3

Variable name	1979.4	1980.1	1980.2	1980.3	1980.4	1981.1	1981.2	1981.3	1981.4	Calendar year		Fiscal year	
										1980	1981	1980	1981
Federal Government expenditures	524.7	538.4	534.4	541.8	562.3	578.3	604.9	630.8	660.8	544.1	618.8	534.8	594.1
Personal income taxes	248.5	246.1	249.2	257.6	268.2	255.7	266.7	277.5	289.9	255.3	272.5	250.3	267.0
Corporate profits taxes	81.4	86.8	70.5	66.1	68.3	75.4	83.9	90.8	100.4	72.8	87.6	76.2	79.6
Indirect business taxes	30.7	33.8	43.0	43.7	49.6	53.5	57.5	61.5	65.5	42.5	59.5	37.8	55.5
Contribution for social insurance	164.1	171.7	171.7	174.5	176.1	193.7	196.8	201.0	205.1	173.5	199.2	170.5	191.9
Federal Government expenditures	540.4	564.1	579.0	607.6	627.7	642.7	659.4	686.9	705.9	592.9	673.7	572.7	654.2
Purchases of goods and services	178.4	186.2	192.5	196.9	207.1	213.6	220.2	227.0	238.3	195.5	224.8	188.5	217.0
National defense	114.6	119.6	123.6	128.4	136.1	142.0	148.0	153.2	161.6	126.9	150.9	121.5	144.8
Nondefense	63.8	66.6	68.9	68.5	71.0	71.6	72.2	73.8	76.7	68.5	73.8	67.0	72.2
Transfer payments	222.7	225.2	236.1	258.2	266.4	272.3	279.2	297.3	302.2	246.8	287.8	235.6	278.8
Grants-in-aid	87.3	86.0	86.4	86.8	87.8	89.0	90.2	91.4	92.6	86.7	90.8	86.6	89.6
Net interest paid	46.2	50.2	54.5	54.9	55.4	56.6	58.4	59.6	61.0	53.7	58.9	51.5	57.5
Subsidies—current surplus	8.8	8.9	9.4	10.8	11.0	11.2	11.4	11.6	11.8	10.3	11.5	9.5	11.3
Surplus or deficit (−)	−15.7	−22.9	−44.6	−65.8	−65.4	−64.4	−54.5	−56.1	−45.1	−48.8	−55.0	−37.2	−60.1

The principal assumptions underlying this table, in addition to the economic assumptions, are as follows:

1. The windfall profits tax will remain intact, but the gasoline import taxes will never see the light of day.
2. The withholding tax for interest and dividend income will not be passed.
3. The $16 billion package of spending cuts proposed by President Carter will not be enacted, nor will any other similar package.
4. Supplemental unemployment benefits will not be increased, unlike the situation in 1975.
5. Congress will pass a tax cut of $30 billion effective January 1st, which will consist of approximately a $20 billion reduction in personnel income taxes and a $10 billion reduction in corporate income taxes through shorter depreciation lives. This tax cut probably will not be passed until early 1981, but will be made retroactive to the beginning of the year.

Under the assumptions, the Federal budget deficit on an NIPA basis will rise from $37 billion in fiscal year 1980 to $60 billion in fiscal year 1981. This sharp increase in the deficit will be due primarily to the recession and the 14-percent increase in Federal government expenditures, much of which is brought about by the higher transfer payments associated with the slowdown. While defense spending is expected to rise some 19 percent, this still accounts for only $23 billion of the total increase of $82 billion which we project for Federal spending next year.

Chairman HOLLINGS. We will now hear from Dr. Perry.

STATEMENT OF GEORGE L. PERRY, SENIOR FELLOW, BROOKINGS INSTITUTION

Dr. PERRY. Thank you, Mr. Chairman. I am pleased to appear before this committee to respond to the questions that you raised concerning the state of the economy and proposals for improving it. I shall organize my remarks around the four issues that you raised in your letter of invitation.

FORECASTS FOR 1980 AND 1981

We are in the midst of a very steep recession. Although quarterly forecasts of real activity cannot be made with great confidence, I shall give you my present estimates as you requested. The recession will reduce real GNP by 4 percent during the last three quarters of the year, and this decline will raise unemployment to 9-percent by year-end. Real GNP for the year as a whole will be down about 2 percent from 1979.

I now expect that the recession will end in the fourth quarter and a modest recovery will be under way throughout 1981. This is by no means assured, and the odds on a prompt recovery—and certainly the strength of that recovery—will depend on the policy actions that are taken. I am assuming budget outlays will total $634 billion as indicated in the revised estimates just released, and I am assuming no tax changes for purposes of this forecast, although I do advocate substantial tax reductions.

As to monetary policy, some further decline in short-term interest rates would be appropriate during the rest of this year, and I can see no reason for allowing a noticeable increase in rates during 1981. My outlook for the economy assumes this will be the case, so that the prime lending rate, for example, will decline below 10 percent this year and will not rise above 10 percent by the end of 1981.

Such a path for monetary policy is certainly not too easy. Yet, there is some risk that policy might push rates up rapidly once the recession ends, or even before it is clearly over. This might happen if policy is excessively preoccupied with the growth in one or the other of the monetary aggregates, or it might be motivated by a desire to support the exchange rate of the dollar. The exchange rate is a legitimate concern, but I would hope we could work out ways to protect the dollar from undue fluctuations without making domestic monetary policy hostage to the exchange rate.

Under these assumptions for fiscal and monetary policy, I expect real GNP to grow between 3 and 4 percent during the four quarters of next year. This would be a very slow first year of recovery. It would leave unemployment at around 8.5 percent at the end of 1981, and for the year, real GNP would be virtually unchanged from 1980.

The underlying rate of inflation, measured so as to abstract from the rise in energy prices, is currently about 9 percent. I would expect it to improve to about 8 percent by the end of next year. The current rate is about 2 points higher than it was in the middle of the decade. The actual rate of inflation should improve by slightly more than the underlying rate, although bad surprises in energy prices or in food prices, both of which are hard to predict and largely unrelated to the state of the economy, could worsen this outlook. Even if they do not, it is clear that recession is not going to cure inflation for us.

THE ECONOMY AND THE BUDGET

The budget deficit for fiscal year 1981 will be about $30 billion, despite the success of the Congress and the administration in holding down spending programs. Nonetheless, the budget will be restrictive because, apart from the effect of the automatic stabilizers which lose revenues and add to transfer payments during recession, it will be moving into surplus in the largest such swing in many years. A steady fiscal policy would not permit such a huge swing.

The budget will have no effect on the fight against inflation, except for two modest and offsetting effects: The scheduled increase in payroll taxes will add to business costs and thus directly add to the price level through that route. At the same time, the restrictive overall thrust of the budget will contribute to keeping the economy underutilized, thus providing the very slight anti-inflation effects that come with a little more economic slack. The deficit will not crowd out productive investment. In an underutilized economy, such crowding out does not take place. A legitimate concern, however, is whether monetary policy squeezes out investment spending. It will do so to the extent that it keeps interest rates too high.

FISCAL POLICY

Fiscal policy should be framed in response both to longer-run goals and near-term stabilization needs. Tax reductions are called for on both counts. If reductions are to be permanent—and they should be—their size must be geared to the longer run projections of budget spending. If defense spending is going to grow a great deal in coming years, realistic projections of that growth will have to be made before the amount of tax reduction is decided on. It is a delusion to believe that tax reduction will somehow enlarge potential output so that these limitations do not have to be faced.

Ideally, the right tax cut for today would lose more revenue initially than it does later on, unless we are anxious to sustain the deep recession we are in. What we want to avoid is a tax cut that leads to rapidly growing revenue losses in later years, when the economy will not be flooded with unemployment and excess capacity and the needs of defense spending will have risen.

For this reason, a proposal such as the 10-5-3 plan for liberalizing depreciation allowances is too costly. I would urge strong consideration of the proposal for first-year capital recovery that has been made by Professors Auerbach and Jorgenson. It simplifies the tax treatment of depreciation; it is correct in principle; and it creates a depreciation system that is not affected by inflation rates.

Heading off the scheduled increase in payroll tax rates for next year should be the most urgent item on the tax reduction agenda. The tax is regressive and it adds to business costs. In order to maintain the contributory nature of the retirement programs financed under social security, it would be appropriate to reduce the payroll tax by reducing that portion of the tax that is used to finance medical insurance, moving the financing of that program over to general revenues.

ANTI-INFLATIONARY FISCAL POLICIES

The one fiscal policy action with a chance to really help slow inflation would be the deliberate targeting of tax reductions to encourage wage and price restraint. A proposal along those lines was made once before in the form of real wage insurance, and it did not get very far. This is understandable in view of the novelty of that proposal. But if we are ever going to get serious about inflation fighting, I believe we are going to have to devise a program that provides rewards, and possibly penalties, for inducing the slowdown in inflation that society demands. The anti-inflation benefits of all the other things we can do with fiscal policy are so small as to be negligible. Tax policies have important roles to play in encouraging efficiency and providing equity. Inflation has distorted the tax system so that these goals are no longer being served as the tax laws originally intended. But changes that would correct for the effects of inflation should not be sold or bought as changes that will cure inflation.

Policies to encourage capital formation are desirable, but are not cures for inflation. They will have only slight effects on the growth rate of productivity, adding perhaps 0.2 percentage point per year to its annual growth rate. Even this small gain is not going to be available initially to enhance aftertax real wages, for personal taxes will have to be higher in order to permit the higher level of investment spending to take place. And even as aftertax real wages do eventually rise, there is no reason to expect the rise will occur through lower prices. The fact is that comparison of productivity growth rates and inflation rates in different countries shows no connection between the two.

I have digressed on this point because of the risk that tax proposals that are desirable on other grounds will be accepted as cures for inflation. When they fail, we will resort to more drastic alternatives, such as rigid controls or another deep recession. The time to avoid these costly mistakes of the future is now. We now have tax reductions to devote to the fight against inflation, and we face the kind of slack in the economy that would give a voluntary tax incentive program for wage and price restraint its best chance of success.

Thank you.

ELIMINATION OF TAX CUT WOULD NOT ERASE DEFICIT

Chairman HOLLINGS. Thank you, Dr. Perry.

Dr. Evans, I want you to elaborate on the statement you made to the effect that if we did not have a tax cut next year, we would still have a deficit of about $45 billion. In other words, the assumption is that we will have a $30 billion deficit by CBO figures, and I think all three of you agree. But if we had the tax cut, it would be nearer $60 billion.

You made the statement to the effect that even without the tax cuts, you could get a $45 billion deficit. Can you elaborate on that and give the rationale one more time?

Dr. EVANS. Certainly. I think the $30 billion number that is put out by CBO is too optimistic. I think it has a somewhat lower rate of inflation built into their forecast than I expect to happen, and therefore I think that Government spending programs that are tied to inflation will rise faster than CBO has indicated.

I also think that they are optimistic about the general control over Government spending in any cuts that might be made.

Working back from the $60 billion figure, the tax cut that I have talked about of $30 billion would not go into effect until the first of the year; in fact, it might be passed later and made retroactive. So, we are not talking about a tax cut over a full fiscal year; we are talking about a tax cut over maybe two-thirds of a fiscal year, which is $20 billion.

For a $20 billion tax cut, we would generate something of the order of magnitude of another $5 billion in revenues, because the economy is growing faster. So, the $20 billion tax cut really only increases the deficit by $15 billion.

TIME FRAME PROJECTION FOR TAX CUT

Chairman HOLLINGS. Ideally, does anyone have a particular view with respect to passing that tax cut? I think Dr. Santow said, politically, it would be maybe this year. But as an economist, Dr. Santow, would you pass it between now and October 1, before we adjourn, so we can run on a tax cut?

Dr. SANTOW. No, sir.

Chairman HOLLINGS. Does anybody believe we ought to pass that tax cut between now and October 1?

Dr. EVANS. No, I do not.

Chairman HOLLINGS. What is the salient feature, Dr. Perry, of withholding a tax cut action until, let us say, the beginning of next year and make it retroactive? I think everyone would agree that it should be effective for calendar year 1981.

Why is that desirable? Do we look more sane or less naive, or more competent? [Laughter.]

CAREFUL DELIBERATION NECESSARY IN DISCUSSING TAX CUT

Dr. **Perry**. I think that for the most part, it would pay to trade careful deliberation for speed in discussing the tax cut. The one tax change which I think could be made and would be useful—and it has been discussed for a long time, so it would not require a great deal more discussion—is the payroll tax increase which is coming up on January 1.

If one wanted to head that off, I think that could be done promptly, and then the changes that are of a more structural nature could be done with greater time for debate.

SHORT-TERM ACTION TO AMELIORATE UNEMPLOYMENT

Chairman **Hollings**. I have one other question. I am going to try to limit myself to a 10-minute rule, and we will pass it around. That has been the procedure heretofore and it has worked very well.

We are all charged with being callous and in total disregard of the poor unemployed; in fact, we have been accused of an affirmative action program to cause unemployment. Now, does anyone know anything that the Congress can intelligently do between now and November to ameliorate that unemployment?

Specifically, Dr. Santow, if the President proposed, let us say, a $2 billion public works and countercyclical program to be triggered at a 7-percent unemployment rate and targeted to the inner cities, or whatever it is, what can be done or should be done?

I want all three to comment on this. What can be done on unemployment between now and when we adjourn?

MAJOR SPENDING INCREASE OR TAX CUT NOT THE ANSWER

Dr. **Santow**. Basically, not very much. I think the point that I would make is that I would not want to see either a tax reduction or a major increase in spending in the next several months that was due more to, as I said in my statement, the heat of the election.

Both Congress and the administration should recognize the true size of the deficit for the next fiscal year. I do not agree with the administration's receipts estimates for next year, even if there were no tax reduction.

With respect to receipts, the administration is using about a $604 billion estimate, I am using $585 billion. My estimate assumes a tax reduction effective July 1, 1981, with parts of it retroactive to the first of the year. The part that is retroactive would be spread out over a period of time after the legislation is enacted. This tax package would mean about a $10 billion or so loss in revenue in that last quarter of the fiscal year (July-September 1981). Since my receipts difference with the administration is close to $20 billion, even if the tax reduction were excluded, there still would be a difference of at least $10 billion.

Summarizing, I do not think you should do anything in the next 2 months in a major way with respect to receipts or expenditures. I think that cool heads should prevail. When Congress comes back in February, it can think about these things, especially since I believe that the economy is going to reach bottom right around the end of the year. If Dr. Evans is right, it may even be a bit earlier. Thus, the recession is not going to deepen and as a matter of fact we are already seeing signs of the recession starting to moderate with the economy bottoming out.

Chairman HOLLINGS. Dr. Evans, what should I do about unemployment between now and when we adjourn in October?

NO SHORT-TERM SOLUTION FOR UNEMPLOYMENT

Dr. EVANS. Nothing. In fact, I think it would be a grave mistake to try and jimmy the economy around on a short-term basis. In fact, that is what has gotten us into the mess that we are in now, because for some reason, fiscal policy is too often aimed at what is going to happen in the next 6 to 9 months. We need to look at the effects of fiscal policy over the entire business cycle.

If we go around jimmying the economy and if we lose whatever advantages have come out of the recession in terms of reducing inflationary expectations and just go right back where we were, we have lost everything we have gained and a great deal more. I think we just have to, at least for a few months, sit this one out.

Chairman HOLLINGS. When you say "jimmying," you are talking economically, not politically?

Dr. EVANS. That is right. [Laughter.]

I testify every year about how big the tax cut should be. Things are changing now, but in past years most of the testimony has been around what will be the effect over the next few months or a year. I say that is the wrong way to look at it We have to see what the long-term implications are.

Chairman HOLLINGS. Dr. Perry, is there anything I should do about unemployment between now and when we adjourn in October?

NO IMMEDIATE ACTION FEASIBLE

Dr. PERRY. No, I do not believe there is. I would agree, basically, with what Mike Evans said about the next few months. But I would like to take the opportunity to disagree with what he said about the last few years.

I think the Congress has done a very good job of bringing sense to the expenditure side of the budget. I do not think we should go on pretending that we are jimmying things around, when, in fact, that is not what has happened and that is not what is happening.

I think that expenditure policy has been sane, sensible and well controlled, and that it is not the cause of inflation. We ought to stop talking about things that do not cause inflation, because otherwise we will never get around to actually doing something about it.

Chairman HOLLINGS. Thank you very much.

Senator Bellmon.

COMPARING RECESSION RECOVERY PERIODS

Senator BELLMON. Thank you, Mr. Chairman.

You know, I have been on this committee now for 5 years and we are now right where we were when I came in.

We had Dr. Burns here talking about the recession and what caused it, and I would like, just for my own education, to see if I understand what really happened that got us into this present situation.

Inflation got up to 18 percent; the prime rate got almost to 20. The Fed tightened down monetary policy because, obviously, Congress was not going to deal with those conditions with fiscal policy, so they tightened monetary policy. And the economy has gone into a tailspin, which I think everyone expected; no surprises there.

Now, over the last 2 or 3 months, the Fed has relaxed the monetary policy. The economy seems to be beginning to recover slightly; at least housing has picked up and the auto industry is a little better. It would seem that this is all working, more or less, according to plan, is it not? Are there any surprises here?

Maybe the recession is a little deeper than was planned, but otherwise what are the big surprises; are there any?

Dr. **Evans**. Well, if there is any surprise at all, I think it was that the economy was so resilient to round 1 and round 2 of the Fed tightening. We had a round in November of 1978, and then we had one in October of 1979 of a magnitude that previously had clamped down the economy. But this time it did not work at all; inflation just kept going on, so it took a much more massive shock than had previously been the case to bring the economy to its heels.

I think that many economists such as myself expected the recession to develop sometime last year, and the thing just kept getting postponed. So I would say that was a surprise, but as far as the budget estimate this year, that is not a surprise.

NO REASON FOR CONGRESS TO ALTER FISCAL POLICY

Senator **Bellmon**. If there is no surprise about what has happened, I am not sure that there is any indication that we in Congress should now drastically alter our fiscal policy. It seems to me that the signal here is that we should perhaps remain rather steady on the course we have set. Do you agree or not?

Dr. **Santow**. I disagree. I would not be satisfied with the current situation which are likely deficits of $60 billion this year and $50 billion next year.

Senator **Bellmon**. You say you would not?

Dr. **Santow**. No.

Senator **Bellmon**. What is your remedy; what would you do?

MOVE TOWARD BALANCED BUDGET

Dr. **Santow**. As I stated in my prepared remarks, I would have a program beginning next year that would attempt to move toward a balanced budget. A balanced budget cannot be achieved right away, but a future year should be chosen to prove that it can be done.

Senator **Bellmon**. But using the assumption which we got from CBO, which was for 7.5 percent unemployment during fiscal year 1981, we thought we had a balanced budget.

Dr. **Santow**. All that I can say is I do my own estimates, and at the beginning of the calendar year, the numbers indicated to me a deficit for fiscal 1981 of $30 to $40 billion.

Senator **Bellmon**. Based on what rate of unemployment?

Dr. **Santow**. The estimates are not done on that basis. The primary items used for determining receipts are personal income, corporate profits, and events in the various financial markets, which help give me some insight into estimated individual taxes. Unemployment is more a byproduct that is viewed in a completely different vein.

It is fair to say that the economy did drop more sharply in April and May than anyone would have expected. It was literally a free fall and it would be ludicrous to believe that most people expected a minus 9-percent second quarter real GNP number, although a minus number of a considerable magnitude was expected.

Also, I do have a disagreement here with Dr. Evans. While I think that the economy dropped so sharply in late March, April, and May because of all the factors that you mentioned, there were many people who were going to buy cars and houses whose spending plans were temporarily pushed to one side. They are now coming back so you have 3 to 6 months of pent-up demand by purchasers. The question then is where does the follow-through come after that? Thus, the numbers that you may see in the next few months in housing starts or retail sales will not indicate a "V" shape recovery. There are people pushed out of the market who have come back, but the question of a follow-through later on is another matter. Therefore, I do not agree with Dr. Evans' housing starts estimate for next year.

CBO ESTIMATES NOT INFALLIBLE

Dr. **Evans**. Let me just say something so my views do not get distorted here. They may be wrong, but I do not want to be misunderstood.

What I was saying, I thought, clearly, was that we are about right now, in GNP and so forth, where I thought we were going to be a year ago. Now, what happened was that we kept going up and then we crashed, instead of going down. In that sense, the record 9-percent decline in the second quarter was sharper than anybody expected 3 months ago.

But as far as where we are now, this is the sort of thing I was testifying about last year. I mean, we all make errors; I am probably at the top of the list. But there is absolutely no reason to expect that the CBO estimates should be carved in stone. In fact, most economists would have argued that those CBO estimates were never very good.

So I think that is, in a certain sense, a strawman to say that we relied on the CBO estimates and now we should not change anything because CBO's estimates were incorrect, just like a lot of other people's estimates.

Senator **Bellmon**. Dr. Perry.

ALTER CURRENT RESTRICTIVE FISCAL POLICY

Dr. **Perry**. Well, Senator, you did ask about surprises, and it seems to me, in considering next year, that the question is not whether one would be surprised, but whether one would be pleased.

I think that for some time now, analysts have looked at budget projections and where the economy was likely to head under the kind of path that fiscal policy was geared to, and saw a very depressed economy by 1981, quite apart from the exact timing of a recession and the fact that it came very steeply this spring.

So, I do not believe the question is one really of being surprised, but of whether you like what you see. The surprise, of course, would be if the economy was in much better shape. So, I think that if you do ask the question that way, you may want to change some of the fiscal stance that now exists, just as you may have wanted to change that if you had asked the question 6 months ago or even 12 months ago.

In other words, I think that most economists, if you had asked them to comment on the projection of fiscal policy that we now face and if you had asked them that question 12 months ago, would have told you that it was a restrictive stance and that we probably ought to be thinking very seriously about tax reductions. I do not think that that opinion is one which has formed simply because of the recession; I think that was an opinion formed simply from looking at where the budget was heading.

ROLES OF CONGRESS AND FED OVERLAP IN WAR ON INFLATION

Senator **Bellmon**. What troubles me about the efforts we make here to try to produce a stable economy is that we had both the Federal Reserve, in their management and monetary policy, and the Congress, in our management and fiscal policy, attempting to compensate for the same situation.

If the Fed comes along now, which they have done, and relaxes monetary policy and we come along with a big tax cut, to me the result is that in 8, 10, 12 or 15 months out in the future, we are right back with 20 percent inflation, and then we have to go right back through the recession process again.

It seems to me that at some point in time, the Congress needs to adopt a policy of stability and let the Fed try to use monetary policy to deal with inflation, or we had better get them to have a stable monetary policy and let us have a fiscal policy that tries to adjust for inflation. If we are both adjusting at the same time, we are going to always wind up getting overkill.

DEEP RECESSION POSSIBLE RESPONSE TO RESTRICTIVE FISCAL AND MONETARY POLICY

Dr. **Perry**. Well, let me try to put the dilemma this way. If you could design the perfect fiscal and monetary policy—and I will let anybody you choose define "perfect" in this case—you still might have no good options in terms that concern us all; that is, we might still confront a very deep and long recession as the response to a restrictive monetary and fiscal policy, and that may not be a choice that we really want to accept. Perhaps it is a choice, but I think that is the nature of the problem.

The nature of the problem is that there are no particular dials we can turn which will help us with inflation without this very real cost, and so long as that is the basic dilemma, I do not think that any particular twisting of the dials is going to get us out of it.

DECLINING PRODUCTIVITY UNDERLYING CAUSE OF INFLATION

Dr. **Evans**. Senator Bellmon, I think we all agree that what we really want to do here is to get the rate of inflation down to a reasonable level. I believe that the best way to do that is, as I mentioned earlier, to divert resources to investment, to provide tax cuts to stimulate savings and investment, and to reduce the growth rate in Government spending.

Now, Dr. Perry has testified that policies for stimulating investment are not cures for inflation. I would categorically disagree with that. In my personal opinion, that statement is incorrect.

I think that, in fact, we are going to have to attack inflation by attacking the underlying problem of the decline in productivity. Until we can turn productivity around, it is my opinion that we are not going to get inflation under control, even if the budget were to be balanced. That is why I think I am willing to have tax cuts which stimulate savings and investment, and couple those with growth limits on Government spending.

DEVELOP 10-YEAR TAX PLAN

Dr. **Santow**. I want to make two points here. One is that if you do come up with a tax plan for the decade—and it does not have to be the program that I suggest—if it is $100 billion in total, it would be $10 billion a year. Ten billion dollars a year in tax losses to the Treasury is rather a negligible amount, but in terms of inducements for the businessman and the individual, it could be consequential. He or she would know over the next 9 years where tax policy is going. This would be a proper approach because fiscal policy has always fallen down on trying to cyclically fine-tune the economy because it is complex and it is very difficult to get things done. Moreover, from a proper timing viewpoint, it never seems to work.

My second point is that when the numbers come out in the second budget resolution, I hope that they are more accurate than the administration estimates for fiscal 1981. It is of great importance to come up with as accurate estimates on receipts and spending as you can for the second resolution, so that when Congress returns in February, it will be working from proper budget projections rather than working from inaccurate estimates.

Senator **Bellmon**. Where do we get that?

Dr. **Santow**. You should use a combination of advisers, including your own CBO staff. I would be willing to regularly give you up-to-date estimates. I am sure other people will do the same.

Chairman **Hollings**. Can you give us a copy later on, Dr. Santow, of your assumptions for 1981—the ones that you put out, I think, in the Schroeder report?

Dr. **Santow**. Yes.

Chairman **Hollings**. We would appreciate it later on for the record.[1]

Senator Exon.

---

[1] Not received at time of printing.

INFLATIONARY NATURE OF DEFENSE EXPENDITURES

Senator EXON. Mr. Chairman, I would like to ask the members of the panel this morning—I am strongly for increased defense expenditures, and we have not gotten into that very much. When we talk about inflation, we kind of shun that.

Is it not true that defense expenditures are highly inflationary?

Dr. PERRY. No.

Dr. EVANS. No.

Dr. SANTOW. No.

Senator EXON. They are not?

Dr. PERRY. No.

Senator EXON. Why are they not highly inflationary?

Dr. PERRY. Well, they are no more inflationary, I suppose, than expenditures on anything else. That is the short answer.

Senator EXON. In other words, if I understand you right, if we are going to increase defense expenditures by $18 to $20 billion, that is no more inflationary than if we had put that $18 to $20 billion in increased unemployment benefits or increased medicare or in any of the social programs?

Dr. PERRY. Well, it is easier to make a comparison, between tanks and cars, or something like that, because you do get into some second or third-order effects. If you talk about transfers, they may not have the same effect on total activity in the economy.

But that is right; as between civilian and military expenditures, whether we make them or whether you make them, I think there is no reason to distinguish the inflationary impact.

INFLATIONARY IMPACT OF INCREASED UNEMPLOYMENT INSURANCE

Senator EXON. But I specifically want to get into the matter of an $18 to $20 billion increase in military expenditures, which I emphasize I am strongly for. Does that have the same increased inflationary pressure as if we would add on, for example, to unemployment—I understand, of course, that we have the entitlement programs in unemployment, but suppose we would decide that we were going to increase the benefits for unemployment insurance by $18 to $20 billion. Would that have the same inflationary pressure as the $18 to $20 billion in the military?

I suspect not, because we are supposedly going into productivity with this. Is that the right assumption?

Dr. SANTOW. Before I answer your questions, I should tell you that I have a certain viewpoint, having been in the Air Force Reserve for 23 years.

The points I want to make are as follows: First, I believe that defense spending should be based upon defense needs, not upon whether spending is viewed as inflationary or no inflationary. Second, if you look at some of the avionics and research and development that has gone into many defense items, you will find that there have been important civilian uses for those items later on. There have been considerable gains in the civilian sector from many products and processes that were developed in the military sector. Third, there really has not been an explosion in defense spending. If you go back before the SALT II discussion and look at the individual projects, and the likely costs of those projects, there has not been any major increase in defense spending that one could not have figures out 9 months or 12 months ago.

Finally, I will point out to you that in this fiscal year defense spending will be about $135 billion, up from about $115 billion last year. Next fiscal year, the total will amount to somewhere between $155 and $160 billion. Now, a $25 billion increase in a $2.3 trillion economy in my judgment, is not a huge amount. Given our situation with respect to the Russians, it seems to me that it is not an excessive amount to spend.

Senator **Exon**. Well, Dr. Santow, that is not the point. I agree with you that it is not an excessive amount to expend. But what you are telling me is, not only is it not an excessive amount to expend because we need that for defense purposes, but you are also saying that $18 to $20 billion of expenditure is, in your opinion, not significant as far as inflation is concerned.

Dr. **Santow**. That is correct.

Dr. **Evans**. I would make several points, some of which I agree with Len on. I think that on the productivity issue, the spill-over in the development of new weapons and avionics systems does increase productivity, whereas the increase in, say, unemployment compensation or other welfare payments has, at best, no effect on productivity. According to some of the studies that we have recently done, it actually diminishes productivity because it harms the work ethic. I would not want to say that that is the major effect, but if there is any effect at all, it is in a negative direction. So, on balance, defense spending is not as inflationary as some other types.

I would also point out that a decade ago, we spent more or less 10 percent of the GNP on defense, and now we spend about 5 percent of GNP on defense, and I have not noticed that the rate of inflation improved because of that.

Senator **Exon**. I have no more questions.

Chairman **Hollings**. Good.

Senator Domenici.

ABANDON BALANCED BUDGET OBJECTIVES FOR 1981

Senator **Domenici**. Let me say that I have been very interested in the differing views that the three of you have given us. I think you must share some of our frustration while, at the same time, you direct some of your concerns at the budget process.

You talk about a 10-year plan in taxes for consistency and so that the people out there in the private sector and otherwise will know where we are at. I hope you all know that under existing law, we prepare one binding budget per year and we have no way to affect out-year taxes. So, if there is going to be a 10-year plan, other than by some direction in terms of persuasion it does not come out of the budget process.

If we had our opinion and could produce the kind of 5- or 10-year plan you are talking about, we probably would not be looking at 1 year at a time either, and thus suffer the aberrations in the Federal Reserve and other things.

Having said that, let me get down to the specifics of this year. CBO and the administration indicate that the fiscal year 1981 deficit will be between $27 and $30 billion, based on revised economic forecasts. There is a suggestion that we ought to take a better look, but aside from that, should Congress abandon the balanced budget objective in 1981?

BALANCED BUDGET FOR 1981 NOT POSSIBLE

Dr. **Santow**. It is not a question of abandoning it. Rather it is not possible, it literally is not possible to achieve. I cannot figure out a method whereby you can achieve a balanced budget for fiscal 1981. The only thing that you can do is work at the margin and move in the direction of a balanced budget. Assuming that my deficit estimate for next fiscal year of about $50 billion is correct, if that deficit could be limited to about $40 billion of $45 billion through reductions in spending, that would be a reasonable accomplishment. To repeat, for you to think that you are going to get a balanced budget in the next year or so just is not realistic. There is just absolutely no chance of it happening.

Senator **Domenici**. Does your deficit have a tax cut in it?

Dr. **Santow**. Yes, a $30 billion reduction effective July 1, 1981, with parts of it retroactive. Thus, the Government would only lose the receipts in the last quarter of the fiscal year. On a net basis, the Government would lose about $10 billion in tax receipts in the July–September quarter, and that would mean about $585 billion in receipts for the year. The administration's $604 billion receipts number is overly optimistic.

Senator **Domenici**. Well, you say it is not possible to have a balanced budget. I was being somewhat facetious in talking about abandoning it. When you use the words "it is impossible," do you mean economicwise, or do you mean, literally, it is not possible?

Dr. **Santow**. Literally, it is not possible, there is no possible way that it can happen. Especially important in this regard is that when this committee uses estimates that are not possible, such as a balanced budget, any work that you may do to limit the size of the deficit gets covered over. Thus, if earlier, in the year this committee had estimated a deficit for fiscal 1980 of, let us say, $60 billion, and then had worked to limit the deficit to $55 billion by holding down spending, it seems to me that the value of the committee's work would be evident. In fact, this committee has done some good work in limiting spending, but the problem is that any achievements are washed away when you pass a balanced budget resolution and then several months later you have to admit to a large deficit.

BUDGET CUTS STEMMED FROM DEMAND FOR BALANCED BUDGET

Senator **Chiles**. Well, that is easy to say sitting where you are sitting. The other side of that problem is that we never would have cut $20 billion off the current growth of this budget but for the fact that we were holding out to the troops that we thought we could balance the budget.

We never would have passed a reconciliation of cutting $4 billion if it had not been for the fact that that was necessary to balance the budget. You know, your pronouncement is very good from where you are sitting, but I can guarantee you that you would have not had $20 billion cut if we had taken the assumption of, well, we probably are not going to balance the budget anyway. Once that hit, you would not have done that. If anything, this budget would be not $20 billion, but I think considerably more in deficit.

Yes, we wanted to believe the best news we could hear, and only because of that and because the balanced budget fever hit here were we able to make those kinds of cuts. It would have been nice to have said to the public, "Yes, it was going to be $55 billion and we cut it to $35 billion," or whatever it was. We never would have had that opportunity to do it because we would have never had those cuts.

Senator DOMENICI. I agree, Senator Chiles.

Would the others comment on that?

Dr. EVANS. Well, about the balanced budget next year, I would not say it was literally impossible. You could always raise taxes enough to balance the budget, if you wanted to, but I think that would be a very poor idea.

The idea is to balance the budget over the cycle; that is what I always thought. That used to be considered a liberal point of view; now, I guess it is conservative. But I do not think that it is reasonable to try and balance the budget in a year of recession. I think we ought to try and balance it over the cycle, but we have obviously not succeeded in that.

So, in terms of abandoning balancing the budget, which was your original point, I think that the Budget Committee should work very hard on trying to limit the growth in Government spending to the rate of growth in GNP, and perhaps do a little better than that. I think that would be a signal accomplishment.

As far as balancing the budget in a recession year, it could be done, but I do not think it would be worth the price. I think we ought to save that until the economy is in better shape.

Senator DOMENICI. Dr. Perry?

Dr. PERRY. Well, I certainly agree with Mike Evans. The deficit, I think, as we all know, is here because the economy is in a very deep slump. I really do not think the committee ought to criticize itself for that outcome; it is a desirable outcome. It would be quite undesirable to try to undo it. If anybody thought that there was any great symbolism in it, we could pass a 6-month increase in the corporate income tax, or triple it. Then we could all say we balanced the budget. However, it is not a question of whether it is literally impossible, but whether there is any reason to want to pursue that course.

Senator DOMENICI. Well, should we abandon the general policy of fiscal restraint that is in the first concurrent resolution? When you look at programs other than the national defense, they are certainly growing at a far lower rate than the historic trend lines. Should we stay on that or not?

Dr. PERRY. The budget is moving so sharply toward restriction that I think it is appropriate to undo some of that. It is quite a separate decision as to whether you want to deal with the expenditure or the tax side, but I think there is a broad consensus that that kind of relief should come on the tax side at this time.

Senator DOMENICI. Dr. Evans?

Dr. **Evans**. Well, I think you should definitely hold the line on Government spending, as I said. You certainly should not let fiscal restraint go to the winds, just because we move into a deficit situation. It is even more important to try and keep things growing at a reasonable pace so that we can finally get back to a balanced budget 2 years from now.

Dr. **Santow**. The point I made in my original statement was that in at least 1 year in every cycle, you ought to be able to balance the budget and that would logically occur after a major economic recovery.

Using that philosophy, pick a target such as fiscal 1983 or fiscal 1984 to balance the budget. Between now and then, operate with that goal in mind.

DIFFERENT APPROACH NEEDED FOR BALANCING THE BUDGET

Senator **Domenici**. Well, the problem is that we picked it in 1979 as being 1981. [Laughter.]

In 1978, we picked it as 1980. We kept slipping it a year and now it has slipped again. Maybe you are suggesting that we need a different approach to getting there other than merely setting the goal.

Dr. **Santow**. Yes. Limitations on spending increases each year should be used with the percentages gradually declining until a balanced budget is reaches. Start with say a 9 percent growth limitation on spending in fiscal 1981, then 8 percent the next year, 7 percent the following year and so forth, until you attain a balanced budge.

Dr. **Perry**. If I may just add something to that, I would like to categorically disagree with this whole approach to how to run the economy or the budget. There are very serious issues involved in item-by-item, program-by-program expenditures, including the one that we have addressed this morning, which is the need to substantially increase defense spending.

There is absolutely no economic virtue in simple rules that would constrain you in deliberating thoughtfully about those issues, one at a time; I think there is no virtue to it. There is no comparison with other countries who have performed better or worse than us that would lead you to that kind of approach to the budget. I think it is a substantive issue and it is not an issue that can be solved by slogans or simple rules.

Chairman **Hollings**. Senator Mitchell.

INFLATION—CAUSES AND CURES

Senator **Mitchell**. Thank you, Mr. Chairman. I just have one question.

In the course of some of the answers, Mr. Evans was quite concise about what he thought caused inflation, and quite specific about what should be done to cure it. I wonder if, in comparably concise fashion, Mr. Perry and Mr. Santow could tell us what they think causes inflation and specifically what could be done to cure it.

Dr. **Santow**. My opinion is quite close to Dr. Evans. Inflation is not a simple situation to analyze and in recent years there have been a combination of factors which have been the primary causes. One has obviously been the huge increase in oil prices and other energy costs; the large budget deficits have also been inflationary. The tying of pension and labor contracts to cost-of-living adjustments has also created a rising underlying inflation base. Lastly, a lack of productivity has significantly hurt this country in terms of inflation over the last several years. If the country runs at minus productivity as it has in the last year and labor settlements run 10 percent to 11 percent a year, it is difficult to avoid double-digit inflation.

Senator MITCHELL. That is the first part of the answer. What about the second part; what should be done?

Dr. SANTOW. As I have stated previously on the fiscal side, there should be a 10-year $100 billion tax reduction package with substantial tax incentives given to the business community. Call this approach supply-side economics, if you will, but it is an attempt to get business to spend and to put people back to work in productive jobs.

Senator MITCHELL. That would have no effect on the first part of the problem, the increase in oil prices, would it?

Dr. SANTOW. No, it would not.

Senator MITCHELL. You identified three factors, one of which you are suggesting is uncontrollable from our standpoint?

Dr. SANTOW. Not totally, uncontrollable, except in the short run.

Senator MITCHELL. Thank you. Dr. Perry.

NO CONNECTION BETWEEN BUDGET DEFICITS AND INFLATION

Dr. PERRY. Let me start with a few things which are not answers. There really is not a connection between budget deficits and inflation.

Senator BELLMON. You say there really is not a——

Dr. PERRY. First, there is not. I think that a casual analysis of history will show that. Even a casual comparison of the United States with countries like Germany or Japan, for instance, or others that have substantially less inflation than us will show the same thing.

So, I do not think that we should be twisting important decisions out of shape in the vain hope that that is the answer to our problem.

Second, productivity certainly has exacerbated our problem in the last few years. But there is a much more important question that you have to ask, which is, Is there anything that you can do about that?

We all wring our hands over productivity and we would all love to have more of it. It is one of those things which, to the extent you get it, everybody is better off. That is a very, very different question than saying, "Do I have a tax bill that will increase productivity?"

You have to assume that businessmen are very stupid, which I do not believe for a moment, to believe that some form of tax relief would generate wonderful productivity gains. It cannot be so; it is a stupid businessman's theorem. It says that there is something almost there and they just will not go get it; they need a push from us. That is not the way the world works.

We indeed have had a productivity problem in the last few years, but it is not one that we can solve by tax changes. Quite frankly, its sources are not well understood, and they probably have a good deal more to do with the labor force than they do with the capital stock. But I think it is important to realize that that is not a problem that we can easily solve.

Also the contribution that we can make to it is quantitatively small. That, I think, should not inhibit us at all from making important and needed tax changes in the area of capital formation and in the taxation of capital and income. But we should not do those in what again will prove to be a vein hope that they will solve inflation.

GEAR TAX SYSTEM TO WAGE AND PRICE PERFORMANCE

The fact is that inflation is a very stubborn beast. In my opinion, the one constructive approach to the problem as it now stands would be an attempt to put together a more serious income policy than we have ever had in the past.

I think that a policy which used the tax system to provide both rewards and penalties for moderation in wage and price performance is the one thing which has some chance of a payoff. That is a kind of clumsy and awkward program; it is not the sort of thing we are used to doing. But I have spent a lot of time puzzling over what inflation is all about and I am led to believe that what we need is that kind of approach, together with a fiscal and monetary stance that is not overly expansionary. Both are necessary if you hope to collect the dividends from fiscal restraint in the form of lower inflation rather than simply collect a burden from fiscal restraint in the form of more and more unemployment.

What you are trying to do is convert your good fiscal and monetary policies into reduced wage and price inflation. I think a direct approach to that problem is the only one that really has much to offer.

Senator MITCHELL. Could I just ask one more question, Mr. Chairman?

Chairman HOLLINGS. Surely.

RELATIONSHIP BETWEEN SIZE OF BUDGET DEFICITS AND INFLATION

Senator MITCHELL. You state so confidently that there is no relationship between budget deficits and inflation.

Dr. PERRY. Yes, sir.

Senator MITCHELL. Can you explain how something you believe is so obviously untrue is so widely believed by numbers of Americans that must approach the Ivory Snow 99.44 percent figure?

Dr. PERRY. Well, that, I suppose, requires a sociologist, or something of that sort. But the obvious analogy with personal finances is, I think, one thing that gets in the way. People have a hard time getting over the notion that a deficit is a bad thing, and if you have a problem lying around, that does get blamed.

The facts are not subtle. You can look at the United States and you will find that the connection is not there. Perhaps more significantly, look at Germany, who we sometimes think has found the miracle cure for all these things. Their deficits are four or five times the size of ours, typically, and is not a source of inflation.

I do not know a brief way to go through the analytics on this question, but it really is not a subtle matter; the facts stand out rather strongly. Of course, the one obvious thing in this is that we get our largest deficits when we have big recessions in this country. To the degree that those periods moderate inflation a little bit, you will get some of the negative connection; that is, you will find that inflation is somewhat slower with large deficits. But that effect is really quite small; I would say you should regard it as having no connection rather than a negative one.

Senator **MITCHELL**. Thank you.

Senator **BELLMON**. Mr. Chairman, before we leave that point, could the other panelists comment on whether or not they agree that there is no connection between the size of the deficit and the rate of inflation?

BUDGET DEFICIT FINANCED THROUGH FEDERAL RESERVE

Dr. **SANTOW**. I think there is a connection.

Dr. **PERRY**. On what basis?

Dr. **SANTOW**. First, the deficit has to be financed. Also, there is truth to Dr. Evans statement that the spending areas that cause the deficit could strongly influence its inflation impact. Finally, the relative size of spending and the deficit compared with the size of the economy are important inflation considerations.

With respect to financing the deficit, it is going to be financed through Federal Reserve operations. This has generally meant an overly easy monetary policy during those periods of large deficits. One should not center the blame on the Federal Reserve for supplying much of the reserves to finance these deficits.

In contrasting the United States with countries such as Germany where there is a very large budget deficit, the bundesbank can be much tighter than the Fed because of domestic goals and considerations. Moreover, the Bundesbank will place much more emphasis upon international considerations than can or does the Federal Reserve. Thus there is a different mixture between monetary and fiscal policies. The Bundesbank can find it more politically tolerable to have a much tighter monetary policy over a cycle than the Federal Reserve in order to offset what are fairly sizable budget deficits. Also, if you look at the expenditure side of the budget in many countries, you will find heavy emphasis placed upon economic growth and stimulation of capital equipment.

Dr. **PERRY**. If I understand correctly, the issue is not the deficit, but whether the Fed chooses to be too expansive in connection with the deficit.

Dr. **SANTOW**. That is half of it.

Dr. **PERRY**. What is the other half?

Dr. **SANTOW**. The other half is the quality and size of the deficit.

Dr. **PERRY**. Well, just to clarify, the issues are quite separable. If it is true that the Fed is most expansive when the Federal Government runs deficits, then, of course, you might find an accidental correlation which really ought to be attributable to monetary policy. I believe that that correlation, in fact, does not exist, except in war times; that, in fact, Fed policy is independent of the deficit in terms of how fast it is letting the money supply and the aggregates grow. So I am not sure that I would accept even the accidental correlation.

I am not sure what the other half was; it had to do with somebody having to buy the debt. I always learned from you that it is a question of whose debt they buy. Why is it more inflationary if somebody buys a Government bond than if somebody buys a corporate bond, which is the other side of it?

Dr. **Santow**. If the banks buy new Treasury securities, then it is inflationary. If the individuals buy such securities, then it may not be inflationary at all.

Dr. **Perry**. It does depend entirely on what the Fed does in that case, right?

Dr. **Santow**. Yes.

Dr. **Perry**. So it is a question of monetary policy.

Dr. **Evans**. I will very briefly try and get back to the original question. I testified earlier that I thought it was the size of the public sector rather than the size of the deficit that is most important.

Evidently, everybody wants to talk about correlations this morning, and I will join the gang. Basically, people are forgetting about the lags. When the deficit happens and in the year that you are in the big deficit, that is not when the inflation impact happens. It takes a couple of years to work through; this is what I tried to point out in my testimony earlier.

We can cut taxes next year and it will not show up for a couple of years. So, if you redo the correlations between the budget deficit and inflation a couple of years later, you do find more of a relationship than George has indicated. I would like to point that out.

But I still think that the size of the public sector is probably the single most important factor, as opposed to the actual size of the——

Senator **Mitchell**. The record should reflect that Mr. Perry is nodding his head in a negative fashion. [Laughter.]

Dr. **Perry**. I am amazed that we would try so hard to find delicate third-order or fourth-order effects for a phenomenon which is enormous and which needs a response which is appropriate for dealing with such an enormous problem.

Chairman **Hollings**. Senator Hatch.

COULD RECESSION HAVE BEEN AVOIDED OR MODERATED?

Senator **Hatch**. Dr. Evans, when did you predict that the economy was weakening, and that it would be in worse shape than predicted by the Administration and/or Congress?

Dr. **Evans**. Well, I have actually been doing it for some time. I predicted that 2 years ago, and I also predicted last year that we would have a substantial budget deficit for fiscal 1980.

Senator **Hatch**. When the private forecasters had begun to predict the worsening of the recession, the Joint Economic Committee, some others of us in Congress, and some economists themselves recommended that we cut taxes.

If we had coupled a tax cut with enough restraint in Government spending to avoid inflationary impact, could we have avoided or moderated this recession? Why do you think the administration refused to follow this type of advice?

Dr. EVANS. Well, I think the administration's views at the beginning of the Carter administration were very clear. We had just come off of 1976; the unemployment rate was stuck at 8 percent and the inflation rate had diminished to 5 percent.

So, the new administration said, "Fine; we have the problem of inflation licked, so we just have to worry about unemployment and nothing else." They instituted a number of pump-priming programs, and they even suggested a rebate, which was killed a little later. But the general thrust was to try and get the economy moving again.

We had a Secretary of the Treasury who gave the impression that a weak dollar was good for America, because that would increase our exports. So, you had that sort of general philosophy.

And then, 2 years later, when it turned out that all these moves were highly inflationary, then the administration turned around and said, "Well, now we can worry about fighting inflation."

It is very easy to cut the rate of unemployment, if that is all you want to do. You get three guys off the street who do not have jobs and you say, "Here is a job," and your unemployment rate goes down. But you cannot do that with inflation; the lags are much longer.

So, I think the administration was simply guilty of short-sightedness, if not naivete—I am only accusing the administration, not the Congress this time, Mr. Chairman—in trying to solve a two-dimensional problem by only looking at one dimension.

INFLATIONARY NATURE OF TAX CUTS

Senator HATCH. The administration continues to argue, as I view it, that any tax cut that could help us fight our productivity problem in this time of recession would be inflationary. I am correct in that, am I not? I believe that is what their argument is.

Dr. EVANS. Well, I understand the administration to argue as you say, but I, of course, would disagree with that.

Senator HATCH. Do you believe that all tax cuts are inflationary?

Dr. EVANS. Not at all. I think some tax cuts are inflationary; I think some tax cuts are anti-inflationary.

Senator HATCH. Well, can tax cuts be designed to bring more money into savings and investment so that any increase in the deficit could be financed by additional savings, with some left over to finance real growth?

Dr. EVANS. I think that could be done, and that, I believe, would reduce the rate of inflation.

IMPACT OF CONTROLS FOR TRANSFER PAYMENTS ON UNEMPLOYMENT AND RECESSION

Senator HATCH. The standard Keynesian argument, as I understand it, for Government spending as a way to stimulate the economy out of recession was that by spending money on goods and services, Government spending would have a multiplier effect throughout the economy.

However, today, more than half of the Government's expenditures are for transfer payments which do not have, in my opinion, this multiplier effect. Do you believe that developing some kind of control over transfer payments would inhibit the Government's ability to deal with unemployment and recession?

Dr. **Evans**. No, I do not think so. In fact, I think that the entitlement programs should be basically reworked. I think one of the major reasons that we have had this increasing proportion of Government resources relative to GNP has been the entitlement programs. They are designed to help the poor, but as a matter of fact, they have brought on inflation and recession which, to a large extent, have boomeranged on the poor. So, you think you are helping them, but in the long run you really are not.

Senator **Hatch**. Dr. Perry, do you have an opinion on that?

Dr. **Perry**. I do not believe that entitlement programs brought on the recession, but certainly these programs ought to be controlled on their merits. I think that the big difficulty with many of the entitlement programs is that they have grown more than intended; that is, the programmatic aspect has really been more generous or has responded, say, to inflation in a way that has made them grow more than intended.

In programs of low-income assistance, there is such a mish-mash that I think there is a pretty serious disincentive effect built into them. In effect, we have built in a very high marginal tax rate for poor people, and it tends to keep them dependent on these programs in a way that was never intended. So, I think that there are important structural changes that ought to be looked at in those areas.

Senator **Hatch**. Dr. Santow.

Dr. **Santow**. When it comes to the social security program, I have always been a conservative. I do not believe that it should be funded out of general revenues. When Congress votes expenditure increases, at the same time it ought to be willing to vote a tax increase to pay for the increased outlays. If expenditure increases are passed without accompanying tax increases, than Congress loses control of these programs. Funding them out of general revenues is no control at all.

With respect to the administration, I do not have any special insight into their thoughts or ideals with respect to the budget. All I will say is that the administration had a $13 billion to $16 billion budget surplus estimated for fiscal 1981 not much over a quarter ago, and it would have been very awkward, to say the least, to now have to announce a $40 billion or $50 billion deficit. This would have been the deficit range if a tax reduction had been included in the budget numbers.

As far as when I changed my economic forecast, I had expected a minus real GNP in the second quarter of good-sized proportions—4 percent or 5 percent—up to the evening of March 14. After the evening of March 14, I substantially increased the size of the minus.

Senator **Hatch**. Mr. Chairman, I only have one more question.

Chairman **Hollings**. Surely.

INTEREST RATES VARY CPI PROJECTIONS ON INFLATION

Senator HATCH. Gentlemen, we were told at the time of the first budget resolution that the CPI was overstating the rate of inflation, frankly, because of the included interest cost in the index.

Is it true now that the CPI is understating the rate of inflation for the same reason? And do you think the economy is likely to come out of this recession with a higher underlying rate of inflation than we have seen in the past?

Dr. SANTOW. Wait another month or two or three and you will get some surprisingly small increases in the Consumer Price Index because the interest cost on mortgage rates will drop. Do not be surprised if you see increases in the Consumer Price Index in the next several months that are down to 0.4 percent or maybe even 0.3 percent. Such numbers would clearly understate the rate of inflation.

In my judgment, the highest point for the underlying rate of inflation in this cycle was the first quarter of 1980 at somewhere around 12 percent to 13 percent.

With respect to the last question, yes, we have institutionalized more inflation in each business cycle. It seems as though the bottom for inflation is higher in each cycle.

CONTINUE TIGHT CONTROL OVER SPENDING

Senator HATCH. Well, does this not make it particularly important to continue to try to exercise tight control over spending?

Dr. SANTOW. Absolutely.

Senator HATCH. Dr. Evans.

Dr. EVANS. As far as the CPI goes, it is true that it was overstated because of the interest rate going up. I should point out that this is not a symmetrical process. The mortgage rate was 9 percent; it went up, the way they measured it, to about 13.5 to 14 percent, and now it is going down to 12 percent. We are not going to get all of the decrease that we got out of the increase, but that is just a matter of arithmetic as to how they put the index together.

The underlying rate of inflation has definitely moved up, and my estimate is that we are stuck at a rate of inflation of approximately 10 percent unless we change our method of tax policy and fiscal policy, in general. It seems to me that not only is this unacceptable, but there is something that we could do about it. Certainly, redirecting the resources of the economy is one way of going about that.

Senator HATCH. Dr. Perry.

Dr. PERRY. We have not mentioned the most obvious thing, which is that energy prices took another tremendous leap upward, and that a good deal of the acceleration that we saw in inflation this past winter was due to that source.

Senator HATCH. But we cut back on our total use of energy, as I understand it, also.

Dr. PERRY. That is correct, but if we are inquiring about what was happening to the CPI, the arithmetic tells you to, I think, look at the effects of energy, which were entirely beyond our control, and the distortions from the mortgage interest rate movement.

When you take those away, I think you had a realistic inflation rate in the neighborhood of 9 percent.

Now, those factors are very real to people who have to pay those prices, but I am suggesting that when we assess our economic performance and where we are, we do want to separate that out. As you look ahead, rising energy prices are still going to be boosting the CPI a little bit, but nowhere near the way they did last winter, unless OPEC gives us another increase.

The question of whether we ought to be pursuing increased fiscal restraint in the face of this really has to be answered, as Mike Evans said in a different connection, what the effect on two things is going to be from that—the effect on the inflation rate and the effect on real activity in terms of profits, capacity utilization, and unemployment.

At this point in time, certainly, the effects would overwhelmingly be to hurt real activity more; they do not have that much of an impact on the inflation rate.

Senator HATCH. Thank you, Mr. Chairman.

Chairman HOLLINGS. Senator Chiles.

ADDRESS PROBLEM SECTORS OF THE ECONOMY

Senator CHILES. Thank you, Mr. Chairman.

The unemployment and inflation experience of the last few years has not followed a classic pattern. Inflation has stayed high, despite the last recession, and unemployment came down much faster than anybody anticipated, and stayed down longer than we anticipated. We kept waiting for it to go up, and only when the interest rate went up did we see the turn in unemployment; now it has jumped very quickly.

I am wondering whether we are looking too much at the overall, macro economy and not enough at the problem sectors, like autos and steel. Dr. Evans, your printed testimony goes into detail about the forecast for different regions. I wonder if you and the other witnesses would talk about the long-term bright and dim spots for particular industries or sectors.

DIM FUTURE FOR AUTO INDUSTRY

Dr. EVANS. My testimony did discuss that, and I personally find it difficult to be optimistic about the domestic auto industry. I think that the domestic auto industry is in very bad shape. I do not think that it will recover very well, and I would expect that the share of imports would increase over time.

In fact, I have previously commented that by 1990, I expect that imports will be 50 percent of the total market, including those imports which are made in this country but still have a foreign name plate.

The Japanese and European auto companies by and large have more money to put into new product development, into productivity increases, into fuel economy, and so forth. The Japanese, for example, have one auto plant which is run basically by robots. The productivity in that auto plant is 20 times the average productivity of auto plants in this country, and yet that is basically our technology that they are using over there. They did not invent this; this is not unknown to this country.

It is not at all clear to me, by the way, why we do not implement similar productivity increases, at least in a few plants in this country. But the auto industry does not seem to be moving in that direction, and so I would say that I believe that the future for that industry is very dim.

CASH FLOW PROBLEMS OF STEEL INDUSTRY

In a similar sense, I think the outlook for the steel industry is also quite dim because of their inability to create new plant and equipment and because of their problems with cash flow. I think those are the dim spots.

The bright spots, as I would see them, is that we do seem to be maintaining our lead for the most part in high-technology industries, in computer and very complicated instrument types of industries. I would expect those to be the bright spots for our economy.

Senator **Chiles**. Dr. Santow?

INDUCE ARCHAIC INDUSTRIES TO MODERNIZE

Dr. **Santow**. Senator, I believe that many of our basic smokestack industries are archaic. There have to be methods to induce these industries to modernize. For each industry, it may require different set of inducements. For example, I am not in favor of across the board 10-5-3 depreciation rules for all industries, or a uniform increase in the investment tax credit. You have to study each industry and find out what package of inducements are necessary.

Senator **Chiles**. How do we do that? I mean, Congress cannot do that, as such.

RESEARCH PROBLEM SECTORS ON INDUSTRY-BY-INDUSTRY BASIS

Dr. **Santow**. You may have to go to outside sources and have a study done and this would involve talking to people in a variety of industries. While you might get some biased answers, at least you would have a feeling of what would work in one industry might not work in another industry. In one industry, the problem may be inadequate depreciation and in another industry it might be the problems of environmental costs in near-term years. With respect to import restrictions or import controls, they do nothing more than to buy time. They do not solve the problems on a long-run basis.

Senator **Chiles**. It may be part of what you would have to do if you had an overall plan to buy some time until you could put the plan in.

Dr. **Santow**. Yes.

Senator **Chiles**. Dr. Perry?

Dr. **Perry**. Well, I disagree basically with the thrust of Congress trying to decide things very selectively on an industry-by-industry basis.

Senator **Chiles**. I just do not think we can.

Dr. **Perry**. No, I do not believe you can very well either, and I think that business——

CREATE FEDERAL AGENCY FOR REVITALIZATION OF PROBLEM SECTORS

Senator **Chiles**. We may be able to create a reconstruction financing and revitalization planning agency.

Dr. **Perry**. I think that industry and businessmen can do those things much better for themselves than we can try to do them for them. I am concerned about the opposite trend, that we might end up trying to back all the losers, and that would be costly to the economy and it would probably do more to damage our productivity and our competitiveness than any other kind of program we could adopt.

Senator **Chiles**. Well, I read an interesting comment in a speech the other day by—I cannot recall the fellow's name now, but he was talking about, you know, how we always say we do not back the losers and we always back the winners. But if we are not going to make a winner out of steel or out of oil production, then we are just going to say we are going to surrender those two losers to the Japanese and Germans. I do not see how we are going to say we are going to do that and not be a country of losers.

Dr. **Perry**. Well, I do not believe that that would be the outcome, but I think we ought to let businessmen work these things out for themselves.

Senator **Chiles**. Well, I am talking about industries now. You are not saying, "back all the losers"; you are not classifying industries as losers, because steel is a loser now and domestic autos are a loser now.

Dr. **Perry**. Steel is close to not being a loser, I believe, but I am not an expert on that. Exchange rates have changed, so that steel which used to be able to undersell us sharply is no longer in that position.

Senator **Chiles**. I thought steel was going much more down the path of being a loser everyday, because they are more archaic everyday. I think the long-run projection for steel is as bad or worse than it is for automobiles.

Dr. **Evans**. I think the steel industry is in sad shape and the imports are now increasing as the world economy slows down. I would categorize steel the same way you did.

Senator **Chiles**. Go ahead. We do not want to get off on that.

STREAMLINE DEPRECIATION ALLOWANCES AND TAX SYSTEM

Dr. **Perry**. Well, I will back away from defending the proposition by reaffirming that I am not an expert on that; I should have just left it at that.

I think that in the social regulation area there may be some stronger case for tailoring, or for at least not doing the opposite of tailoring, which is to try to do that job in a way which is not cost efficient for individual industries. But apart from that, I think we should be moving in precisely the opposite direction. We should be moving to not distort the choices of business that they would otherwise make; have a tax system and system of depreciation allowances that let efficiency rule in industry.

I think that in the context of changing the depreciation rules, which is an important item on the Congress agenda, that is the kind of place where you ought to look for streamlining and going to rules that business can optimize within, in a way that is efficient for the economy as a whole.

TAX CUT FOR PROBLEM SECTORS OF THE ECONOMY

Senator **Chiles**. Well, given the fact that steel as a sector and autos as a sector have always been such leading parts of our economy, including our work force, and given the fact that we have this thrust for a tax cut that is going to be born here before long, and it is just a question of what its characteristics are going to be, most of your statements seem to indicate that just 10-5-3, especially if it just goes out across the board, is not going to yield us back what it is going to cost us, especially looking at these problem areas that we have.

We are now getting away from the inflation/recession cycle that we are in. Looking at these troubled sectors that we have that look like they are going to be even more trouble, and there may be some others, should we be thinking about this tax cut in a way that it is going to permanently redress and reindustrialize, as someone has used the term, these smokestack industries and these other major parts of our economy, and seeing that as being one of the big problems—as big as trying to say we are looking for an immediate stimulus, a quick fix, or we are even looking for something that we think will someday help productivity in general, as opposed to those industries?

CREATE INVESTMENT INDUCEMENTS OR BAIL OUT FALTERING COMPANIES

Dr. **Santow**. It seems to me that based up on political realities, you have a choice of two approaches. One is to create investment inducements; two is to bail out some of the companies later on. I would rather have the preventive medicine at the beginning rather than bailing out the companies later on.

Senator **Chiles**. I think that is a good point. We have gone through the Chrysler situation and do not want to continue to have to deal with that.

Mike.

IMPACT OF FEDERAL REGULATIONS ON INDUSTRIES

Dr. **Evans**. I think that certain industries have had to bear a much greater burden of Government regulation than other industries. By cleaning up the air and cleaning up the water and creating safer working standards, and so forth, we have accomplished something that is very valuable. But the burden has fallen very unevenly on certain industries; autos and steel, of course, being two of the major ones, and nonferrous metals and chemicals being others.

I think we ought to take into consideration and into account the fact that these industries have been much more heavily burdened and that we could use tax legislation to offset some of the burdens. I have said for a long time that I think we ought to have short writeoffs for, say, pollution abatement control equipment. I think that this is part of the problem that the auto and steel industries have been suffering under, and so I think we should help them in that direction.

As far as setting off an overall plan to try and have Congress pick losers and winners, I cannot go along with that. I think that broad-based tax cuts and marketplace decisions probably will work out better in that case.

Senator **Chiles**. Thank you.

KEMP-ROTH ACROSS-THE-BOARD TAX CUT

Chairman **Hollings**. On the across-the-board tax cut, as I understand it, Dr. Evans, you recommend about a $40 billion tax cut for next year. You said it would not be inflationary; it would include depreciation allowances, reduction in the corporate tax income, the increase in exemption on interest and dividends, and restructuring of the capital gains tax.

Dr. **Evans**. Yes.

Chairman **Hollings**. And then you comment on the recent proposal by Governor Reagan which is identical to the first step of Kemp-Roth, which you do not favor, I take it. Is that a change of mind?

As I remember, you did testify in March of last year something along the lines in support of Kemp-Roth. There is a change of mind or a misunderstanding.

COMBINE KEMP-ROTH PROVISIONS WITH LIMITS ON GOVERNMENT SPENDING

Dr. **Evans**. Actually, in many people's minds I have been associated as being in favor of Kemp-Roth. What I did testify to was that if we had a Kemp-Roth tax cut without any offsetting changes in Government spending, that would be mildly inflationary; it came out that it would raise inflation about 2 percent.

If we had Kemp-Roth with limits on Government spending, where Government spending would increase only by the rate of inflation—in other words, no real increase—I would be in favor of that package, and that is still my position here. But an across-the-board tax cut without an offsetting limit on growth of Government spending, I do not think, is as appropriate.

Chairman **Hollings**. I was alluding to cuts in personal income which Kemp-Roth, across-the-board, would give. You do not recommend that?

Dr. **Evans**. No, not unless it would be coupled with Government spending cuts; in other words, all alone and by itself, I would rather see us go the direction of these business tax cuts.

WHAT CAUSES INFLATION?

Chairman **Hollings**. As we are closing here, unless the other Senators have questions, Dr. Perry, I have to listen to you a little bit longer. I cannot ever afford your luxury of an analysis that a budget deficit is not inflationary, because if you had the Budget Committee roaming around on Capitol Hill saying, "Do not worry about deficits; we have to talk about productivity; you have to look at Germany," they would get rid of you right quick around here, somehow or another.

It is like the comments made by Senator Chiles to Dr. Santow; I mean, we cannot think as economists. We have to think politically, and it is hard to educate. We are going to have a difficult time educating ourselves and, in turn, educating the Congress into a consensus and into a discipline. We are going to have to try to maintain some kind of discipline in order to get restraint.

What does cause inflation, if it is not Government deficits and the priming of the pump by the Federal Reserve, and everything else? Is it productivity? Is it the high cost of labor contracts? They have gone up 10 to 11 percent.

WAGE AND PRICE RESTRAINT

Dr. **Evans**. The average increase in wage rates is about 8 percent this year.

Chairman **Hollings**. Yes; 6 to 8 percent rather than 10 to 11 percent.

Dr. **Perry**. No. I wish that were true, but labor costs are rising at over 10 percent—hourly labor costs.

Senator **Chiles**. Today, they may be.

Dr. **Perry**. Yes.

Senator **Chiles**. But if we are looking back and trying to determine what got us into this inflation, in the last several years you cannot say labor has been——

Dr. **Evans**. Yes, but labor costs are going up a lot faster than wage rates, and productivity is going down recently.

Dr. **Perry**. We are talking about hourly wages, so productivity is not the issue.

What has happened, if you look at the history of it, is that wages have not gotten way ahead of the game, nor have they gotten way behind the game, except when we got the big fuel price explosions. In those cases, all wages got way behind the game.

I would not single out wages as a special culprit here. I think there is a great inertia in wages; that is, now that they are going up at about a 9 percent rate, they are just not going to stop increasing that fast. That is the dilemma that you really face. Given that they are moving at that kind of a rate, anything you do to slow the economy is not going to slow that process.

You could take them down from 9 to 8.5 percent, but in the process you would take huge gouges out of real activity and all the things which are good for the economy. Capacity utilization is the biggest spur to more investment that we know. It will do a lot more for you or a lot more against you than any tax change you can devise. Yet, the operating rate in steel has dropped to about 50 percent; in autos, it is way down, and it is way down across the board.

So, that is going to be a great disincentive to a lot of things we want to accomplish. It is a very costly way to try to unwind that inflation, when all you get for your trouble is a half a point this year and another half a point next year.

PENALTIES AND REWARDS FOR WAGE AND PRICE RESTRAINT

Chairman **Hollings**. Dr. Perry, how do you factor in these rewards or penalties for wage and price restraint, which is your approach for attacking inflation? How do I congressionally provide for that?

Dr. **Perry**. Well, you have to be prepared to devote some contingent tax reductions to it. The program would presumably involve some standard for wage and price behavior, and that standard would be one that would try to deescalate inflation year by year; say, take a point or two off this year and a point or two off next year. You would be making a lot more progress than we are now.

TAX REDUCTIONS FOR PRICE RESTRAINT

Chairman **Hollings**. I understand the goal, but I am talking about the mechanics of it. If I had Hollings Industries, you say I would have a variable tax rate. If I had upped my prices, then I would have to pay a higher corporate tax rate; if I had held the line, then I would get a lower rate. Is that what you are saying?

Dr. **Perry**. Well, I think the easiest way to sort of conceptualize it would be that it would be on your payroll tax, or something like that, rather than your corporate tax. If your hourly wage costs in Hollings Industries were contained to the guideline figure, you and your workers would get a tax break, and the tax break would make up for the fact that they had taken a more moderate wage increase than they might otherwise have taken, so that the workers would not come out seriously behind in this. If you are willing to spend enough revenue at it, the workers might not come out behind at all.

Now, to the extent that you have a lot of people cooperating and to the extent that the inducement was sufficient that a lot of people held down their wage increases, the next year you are off to a running start. Prices have already moderated, because wages have, and the main determinant of price movements in this economy are wage costs.

Now, it is much easier to take a point or two off the next year, because you have already deescalated from your 9-percent inflation to 7-percent inflation, so the next year the standard becomes 5 percent, with the same sort of inducements.

Chairman **Hollings**. Did you make these tax-cut packages that you all have been discussing here this morning contingent upon wage and price behavior next year?

Dr. **Perry**. Were you asking me?

Chairman **Hollings**. Yes, sir.

Dr. **Perry**. I think this would be a very specific kind of tax package.

Chairman **Hollings**. I see.

Dr. **Perry**. I do not think it would be very easily associated with a general tax reduction, because it has to be a tax package that is aimed at the level of the firm, since that is the unit where wages are set and where you will get a 9-percent increase this year or you will get 7 percent, or whatever it is that is the general increase in your firm. So, it would have to be a program aimed at taxes at the level of the firm.

Chairman **Hollings**. Senator Exon.

INSTITUTE WAGE AND PRICE CONTROLS TO COMBAT INFLATION

Senator **Exon**. I take it from your testimony that you feel that in the next 3 years, regardless of what we do—tax cuts or no, or balanced budgets or no—we are not likely to see less than a 7- or 8-percent annual inflation rate per year for the next 3 years. Is that a fair assumption?

Dr. **Evans**. Yes.

Dr. **Santow**. That is correct.

Senator **Exon**. Given that assumption, are any of you in favor of wage and price controls?

Dr. **Santow**. I am not.

Dr. **Evans**. Absolutely not.

Dr. **Perry**. No.

Senator **Exon**. Thank you.

CONGRESSIONAL ACTION TO CURB UNEMPLOYMENT

Chairman **Hollings**. Finally, on this question of unemployment, I zeroed in on between now and election day. Now, let me zero in on the calendar year 1981, because it is almost like Westmoreland and his meatgrinder approach out in Vietnam, doing absolutely nothing.

Are we going to end up in December 1981 with an 8.5-percent unemployment rate? Are all three agreeing that it is going to be 8.5 to 9 percent all next year, and what would you do next year about that unemployment, as a Congress? Are we all supposed to just go to the club and get a double shot and cry over that and come back again and still do nothing? Is that what you are saying?

Dr. **Perry**. I do think that tax reductions would be responsive to the problem.

Chairman **Hollings**. It would help that unemployment figure in 1981?

Dr. **Perry**. It would be moving in the right direction. I would certainly put a lower best estimate on unemployment at the end of that year if you do pass substantial tax reductions than if you do not.

IMPACT OF RETROACTIVE TAX CUT PACKAGE ON UNEMPLOYMENT

Chairman **Hollings**. If we pass, let us say, next March or April, a tax cut package retroactive, let us say, to January 1, 1981, do you think that by the last quarter, rather than having 8.5 to 9 percent, we could be below 8 percent?

Dr. **Perry**. Well, it is a little quick, but I think you could make a difference of half a point if you had a tax bill that was in place promptly next year.

Chairman **Hollings**. Any other comment? Yes, Dr. Santow.

Dr. **Santow**. I made the point in my paper that what seems realistic is to pick a target date for unemployment, maybe the end of 1982 or 1983 and to come out with a program next year that would take us toward that goal. There is very little you can do in the next 6 or 9 months that is worthwhile on a longer term basis that will bring down the unemployment rate. You ought to aim for a realistic target maybe 2 or 3 years down the road.

Also, I believe that too much emphasis has been placed upon the unemployment rate and not enough emphasis placed upon the growth of total employment. To me, as an economist—although not from a social point of view—the growth in total employment has always been more meaningful. In recent individual years where we have seen 3 million or 3½ million additional people employed, this was quite a good performance, better than what a sticky unemployment rate might indicate.

Chairman HOLLINGS. Dr. Evans.

Dr. EVANS. Well, I think that with a properly designed tax cut which is effective at the beginning of the year, you could probably slice about a half of a percent off of the unemployment rate by the end of the year, so you would end up with 8 percent instead of 8.5 percent.

I do not think you can do better than that; I do not think you ought to do better than that. We are in the middle of a very long, protracted process, and a very painful one, of trying to reduce the rate of inflation on a long-term basis. I think that one of the principal mistakes that was made by President Carter and his administration when they took office was to believe that there was a shortcut to it, because it is perfectly clear that the unemployment rate, as we approach the 1980 election, is no better—and, in fact, somewhat worse—than the unemployment rate was when Mr. Carter was running for election.

So, in 4 years, one way to look at it is, as far as controlling unemployment, he has accomplished precisely nothing. I think that if you could have told him, or anybody could have told him that 4 years ago, I honestly believe he would have proceeded differently. I hate to see us make the same mistake again.

Chairman HOLLINGS. Very good. Any other questions? [No response.] We are really indebted to each of the three of you, and we appreciate it very, very much.

The committee will be in recess until 2:30 p.m., when we will hear from Dr. Heller and Dr. Greenspan.

[Whereupon, at 12:29 p.m., the committee was adjourned, to reconvene at 2:30 p.m. on the same day.]

AFTERNOON SESSION

OPENING STATEMENT OF CHAIRMAN HOLLINGS

Chairman HOLLINGS. Good afternoon.

This afternoon, we meet for the second of five hearings this week in preparation for a second budget resolution markup. Our witnesses are two prominent economists and experienced policymakers, Dr. Walter Heller, professor of economics, University of Minnesota, and Chairman of the Council of Economic Advisers under Presidents Kennedy and Johnson. Dr. Heller was the architect of the Kennedy administration recovery program which ended the economic stagnation of the early 1960's.

Dr. Alan Greenspan, president of Townsend & Greenspan, was Chairman of the Council of Economic Advisers under President

Ford. Dr. Greenspan had to cope with the last deep recession in 1975.

We seek your advice, gentlemen, on the steps that the Congress can take to set the economy on the course of noninflationary recovery. We will first have the opening statements from Dr. Heller, and then Dr. Greenspan. And then we will proceed with questions.

Dr. Heller, we will hear from you, first.

STATEMENT OF WALTER W. HELLER, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Dr. **Heller**. Thank you, Mr. Chairman. To appear before this committee—by the way, I am going to speak from a prepared statement,[1] and with some additions and some subtractions, if I may proceed that way.

Chairman **Hollings**. That is what we had earlier this morning. We had the categorical presentation of one of the economists, and he would not allow us to add and subtract. He wanted us to keep dead on the tail and on target the entire course, and not to do so was either naivete or incompetence. [Laughter.]

But we are glad economists can agree in adding and subtracting, like we politicians have to do.

Dr. **Heller**. Well, I am glad to have your vote in favor of flexibility, because I think both Alan Greenspan and I are a little more flexible than that.

Well, to appear before this committee, which plays such a vital role, not only in budget policy, but in overall economic policy, is always a privilege and a challenge. And I must say that, with the economy, inflation, the budget, tax policy, and politics, all in an advanced state of flux—up for grabs might be a better way of putting it—the challenge is particularly demanding.

THE COURSE OF THE ECONOMY

The first question that you, in effect, put to us was how bad will the recession be and how long will it last. Well, that question, though too narrow, is a good point of departure for appraising the role of fiscal policy.

The best bet now is that recession will run its course by the end of the year, and then turn into a moderate recovery in 1981. That means, by the way, that the recession, as such, is pretty much beyond redemption by policy changes this year. Even if Congress could enact the tax cut in the remaining 40 shopping days until Christmas, the tax cut would have little impact on this year's economy. And with the Fed pretty well locked in on its present monetary course, I would expect relatively little change in the 1980 recession outlook from the monetary side.

The main economic thrust of tax, budgetary, and monetary policy, then, should be on the pace of recovery, and on the prospects for growth and inflation in the 1980's. And there, as I will discuss later, fiscal policy, especially tax policy, has a key role to play.

---

[1] See p. 65.

FORCES THAT MADE A RECESSION INEVITABLE

Now, in thinking about the recession, we should perhaps remind ourselves of the forces that made it inevitable. There is that oil drag that is siphoning about $80 billion a year or more out of our pockets by the end of this year than 2 years earlier. There is the fiscal drag, reflected in the swing from a high employment deficit of about $25 billion in 1978 to a high employment surplus of about $60 billion next year.

And by the way, Mr. Chairman, I use 6-percent unemployment as my benchmark for making that calculation of a high employment budget.

And then, third, we have the monetary drag that was highlighted by the Federal Reserve's credit clampdowns last October and again in March.

Now, it is true that economists missed the call on the timing of the recession. But to many, if not most of us, the fact that it would eventually appear under that triple whammy of the oil, fiscal, and monetary drags was never in doubt. Now, the 1980 recession, itself, is kind of a curious combination of severity and self-limiting forces.

REAL GROWTH OF GNP

In spite of the steep slide in the second quarter, there are no signs that the bottom is about to drop out of the economy. A reasonable forecast would be an overall drop of 4 to 4.5 percent in real GNP between peak and trough, with recovery starting around the turn of the year. Then, even a very modest recovery—that is, modest relative to the average of nearly 7-percent growth, real GNP growth, in the four quarters after the troughs of the six previous post-war recessions. And I think that is worth noting. Our standard operating procedure has been in the year after the trough to have a 7-percent rate of real growth. But even a very modest recovery should carry GNP upward at a 3- to 4-percent pace in 1981. I just pitch it to about 3 percent without a tax cut, and 4 percent with a tax cut.

I might just interpolate there that that contrasts with the administration's forecast which says just over 3-percent drop during the recession, and then a modest recovery next year, just under 3 percent—I guess, 2.6 percent. I might observe that it is pretty refreshing for an administration to forecast falling GNP, rising unemployment and continuing inflation, and then to couple that with a hold your horses position on a tax cut in an election year.

As a matter of fact, I went back to my calendar and made sure that this really was a year divisible by four, after seeing that candor on the part of the administration.

ECONOMIC GROWTH SACRIFICED IN EFFORT TO RETARD INFLATION

Well, as far as the recession is concerned, qualitatively it is distressing but not disorderly. Distress is the order of the day for the unemployed, the overburdened consumer, the whipsawed small businessman and farmer, the soggy auto industry, and we could extend that to steel and housing, and so forth. But there has been no panic in either the financial markets or the consumer or producer sectors.

As far as consumers are concerned, they have taken a severe drubbing but both consumer confidence and retail sales have been steadying and consumer debt formation has been cut dramatically.

In the producer sector, the encouraging thing is that there is no general liquidity crisis, business has been doing a remarkable job of cutting back inventories as sales sag, and there is no wholesale slashing of capital spending plans.

Coming back, for a moment, to our premature forecasts of recession in 1979, I would like to think that our cries of wolf led businessmen and, to some extent, consumers to erect defenses to cope with the beast when it appeared at their door.

Well, in any event, the recession should run its course this year. Now, that does not rule out an increase of unemployment into early 1981. I would expect it to reach a peak somewhat above the administration's new forecast of 8.5 percent, and then back off a bit during 1981, especially with the boost of a tax cut.

But, as noted earlier, the recession is really too narrow a context in which to consider budget and tax policy. In formulating economic strategy from here on out, and especially in structuring a tax cut, we have to broaden our perspective to embrace not just the recession in 1980, but the slowdown last year, and the restrained recovery next year.

OUTPUT GAPS AND COSTS

Now, putting the demand side of a possible tax cut into this broader context reveals that there is plenty of head room for expansion and no danger of triggering renewed demand inflation from a moderate tax cut of, say, $30 billion. Before citing the numbers that lead to this conclusion, one should look back to note that expansion really slowed to a crawl last year. During the year, from fourth to fourth quarters, we only had 1-percent growth in real GNP. So we were already falling behind the economy's capabilities.

And looking ahead, even under the moderate assumption of a 4-percent drop in real output this year, and the optimistic assumption of a 4-percent rise next year, the U.S. economy will not achieve its late 1978 levels of output until late 1981. In other words, in the determined effort to retard inflation, we will have given up 3 years of economic growth.

The next step is to quantify that foregone growth and estimate how much room we have for expansion of output before the economy starts bumping against its productive capacity or potential. Last January's economic report had an estimate of the growth rate of potential GNP for 1979–81, for this particular 3-year period, it reduced it from 3 percent to 2.5 percent a year. And that 2.5 percent consists of a 1.5 percent annual growth in labor input plus a trend increase in productivity of about 1 percent per year.

Now, in my statement, I give the detailed numbers showing how much more we would have produced had we grown at a steady 2.5 percent rate in 1979–81, instead of the measly 1-percent rise in 1979, 4-percent drop this year, 4-percent rise next year. And then to anticipate the critics, I have also done the arithmetic at a 2-percent annual growth rate; that is, assuming a 1.5-percent growth in labor output and only one-half of 1 percent trend growth in productivity. And that, by the way, that 2-percent growth rate would be just half of the 4-percent growth rate we enjoyed in the mid-1960's.

HIGH COST OF FIGHTING INFLATION BY MONETARY FISCAL RESTRICTION

Now, the results are arresting, not to say startling. And I am just summarizing the better part of these 2 pages. At the 2.5-percent rate of potential growth, we would, at today's prices, have produced $125 billion a year more of goods and services in the second quarter than we actually did.

That gap would rise to roughly $200 billion by the end of 1980, and then gradually shrink to $170 billion by the end of 1981. Now, even taking the very conservative 2 percent growth path for potential output, we still see huge shortfalls in output due to slowdown and recession.

For example, we would see a $108 billion shortfall at annual rates in the second quarter, and an $180 billion shortfall at the end of 1980, shrinking to $133 billion by the end of 1981.

Now, coming back to my statement, these calculations tell us, first, that in today's prices, actual output on January 1, 1981, which is the most widely discussed target date for a tax cut, would be running about $180 billion below potential, even on those conservative assumptions of 2-percent growth in potential and 4-percent recession, leaving a wide margin of safety for noninflationary tax cuts.

But, second, they tell us more than that. At the very modest growth rate of 2-percent in GNP potential, the economy would have produced $300 billion more in today's prices than it actually will produce in 3 years of slowdown, recession and sluggish recovery. The costs of fighting inflation by monetary fiscal restriction are very high, indeed.

As I say, on the most conservative of assumptions, our total output will be running, for those 3 years, about $300 billion below what it would have been if we had grown at a 2-percent annual rate.

THE INFLATION OUTLOOK

Now, what are we buying for this huge loss in output and jobs? What benefits can we look for in reduced inflation? Well, on the surface, the answer seems pretty impressive. The consumer price index will drop from its peak of 18 percent in the first quarter of this year to a trough of, perhaps, 6 percent later this year, before rising food prices and probably rising interest rates again push it upward.

Most of the drop is simply a case of letting the air out of the CPI as the artificial bubble created by skyrocketing mortgage interest rates and housing prices is deflated, and as we get some benefit from the letup in OPEC oil price boosts.

But as this committee is painfully aware, what lies beneath the surface, that hardcore or bedrock or underlying rate of inflation, will unfortunately budge very little under the pressures of economic slowdown. The rigors of recession are translating mainly into layoffs and production cutbacks and not into lower wage and price increases. Catch up is still the name of the game in a large part of the labor force. Nonunion wages are catching up with union wages, overall wage increases are trying to make up this year for the gap that opened up between price and pay increases last year.

At the same time, although there is some price cutting and discounting, price hikes in the teeth of falling sales abound in today's recession. When General Motors boosts prices of its average car by $135, as it did on July 1, in an undaunted effort to pass on to consumers a large chunk of its increased production costs, even in the face of the weakest auto markets in recent memory, one is moved to ask, "Recession, where is thy anti-inflationary sting?" Indeed, a major manufacturer was quoted recently as saying, "We had to raise our prices to make up for the loss of volume." Whatever happened to the rigors of the market place?

WAGE AND PRICE INCREASES

Well, undoubtedly, the recession and widespread slack in the economy will have some moderating effect on price and wage increases, but, even at that, it seems unlikely that the rise in average hourly compensation will be cut much below 9.5 percent a year by the time recession has run its course. And given a trend increase in productivity these days of less than 1 percent a year, unit labor costs will be rising 8.5 percent or more per year. This will set a virtual floor of between 8 and 9 percent under our hardcore inflation rate as we enter the next expansion.

In other words, we will come out of this recession with the inflationary gases vented, the glowing bedrock of inflation will recede little, if at all, and will threaten to erupt again when recovery is in full swing.

All the measures on which anti-inflationary rhetoric thrive, such as cutting Government regulatory costs, eliminating unnecessary Federal spending, and maintaining monetary discipline, all of which are necessary, may take some of the edge off of inflation, but unless and until we relieve the relentless force of cost pressures, the prospects for getting inflation back to the 3- to 5-percent area are bleak. If, in the absence of an effective voluntary wage-price restraint program, preferably backed by tax incentives, if a return to economic prosperity in the 1980's brings with it renewed double-digit inflation, and then some, we will be heading directly into mandatory controls.

THE BUDGET IN PERSPECTIVE

One needs not just bifocals but trifocals these days to get a balanced reading of Federal budget developments as they affect the economy. First, a closeup view of just the absolute numbers provides a rather disturbing picture. One need only cite the growth of Federal budget spending in the current fiscal year from the President's original proposal of about $530 billion to a present projection of nearly $580 billion, with a $61 billion deficit attached, as we were told yesterday. No matter how much better the budget may look through other lenses, as I will show in a moment, a boost of nearly $50 billion in this year's expenditures between the time of conception and the time of delivery cannot be deemed tight budgetary control.

But looking through that middle lens, the perspective does improve considerably. This year's budget labors did produce a budget that, leaving tax cuts aside, would have come close to balance under the working assumptions of a mild recession and unemployment peaking at 7.5 percent, and would have produced an impressive surplus in the absence of recession.

DEFICIT RESULTED FROM RECESSION AND SLOW GROWTH

The actual deficit of $30 billion or more, we now face, even in the absence of a tax cut, is a normal outgrowth of recession and slow growth. It threatens no inflationary thrust or crowding out of private borrowing. The Treasury's borrowing needs will be largely a mirror image of shrunken borrowing requirements of the private sector.

I want to expand just a little on that, if I may, Mr. Chairman. I want to note that the $60 billion of borrowing this year—that is Federal borrowing—and the officially estimated $30 billion, or let us say $50 billion with the tax cut, next year, may well be a bitter disappointment for this committee. I imagine it is.

But critics would be well advised to keep a couple of things in mind. First, the committees and the Congress operated in good faith and made painful cuts to keep budget spending and the deficit in check. And second, the rise in the deficit will not boost inflation or interest rates. It is the mirror image of the fall in private borrowing; that is, the Federal borrowing will not displace private borrowing, but instead, will put to use the funds idled by recession.

BUDGET PROCESS ALIVE AND WELL

Let me add a third point that the critics of congressional budget performance should be openminded enough to recognize. Your committee, together with your house counterparts, clearly did a resolute job of reining in budget spending for fiscal 1981, a little too resolute for my taste in the face of a recession.

But that is not the point. The committees were responding in a responsible way to public pressure, even to the point of breaking precedent by specifying $6.2 billion of spending cuts and $4.2 billion of revenue increases as part of the first budget resolution. The alacrity with which the tax and spending committees carried out your mandates is vivid evidence of the fact that the congressional budget process is alive and well. And I say that explicitly because of some contrary impressions that are sometimes released to the public.

Now, still looking through the middle lens—to come back to my statement—one finds, surprisingly, that even with the defense buildup, 1981 budget outlays will be somewhat smaller in real terms than 1980 outlays. And combing out the increase in defense spending—my statement mistakenly says nondefense spending—combing out the increase in defense spending leaves a cutback in real nondefense spending of close to 3 percent.

Looking through the broadest lens, so as to embrace not just spending but taxes, we can get a fix on the full impact of fiscal policy in the course of recession and recovery. And that view shows we are in this sharp swing toward fiscal restriction because tax revenues are trending upward much more rapidly than Federal expenditures. So we are getting this big swing, $85 billion that I have already mentioned, from 1978 to 1981, and most of that swing, $60 billion, is still ahead of us.

THE COMPELLING CASE FOR A TAX CUT

Against the foregoing economic and fiscal background, we can now sum up the cause for action on the tax cut. The following facts confront us. First, there is plenty of slack in the economy. Second, inflation, as reflected in rising pay increases, has been stealthily boosting our personal income taxes. They have moved from 21 percent of personal income in 1978 to 22 percent this year, and they are heading for nearly 23 percent next year.

Third, $18 billion of new payroll taxes—some people use $17 billion, some use $15 billion, depending on different bases; I am using the gross amount—$18 billion of new payroll taxes and a mounting tide of oil profits taxes are coming onstream next year.

Fourth, fiscal policy, as already noted, is swinging hard toward restriction in the face of recession, an almost unprecedented policy circumstance. And fifth, properly structured, tax cuts cannot only remove some of the fiscal overburden that would unduly retard recovery, but could serve as an important weapon in the battle for higher productivity and lower inflation.

And in the light of these realities, I believe we could stand a tax cut tomorrow, if it were possible to wave a magic wand and produce a balanced progrowth and anti-inflationary tax program overnight. But I agree with the administration that under the pressures of an election year, and given the limits of the congressional calendar, this is simply not possible. It is much the better part of wisdom to hammer out a carefully designed tax cut that will advance rather than retard our basic economic objectives.

But I disagree with the administration in its unwillingness to make a firm pledge of a 1981 tax cut, and in thereby suggesting that no action should be taken in 1980. Now, clearly, it is too late in the day for a tax cut in 1980, to apply to 1980. But it is none too late to move on a carefully crafted tax reduction for early 1981 that would remove some of the fiscal drag, offer business tax incentives in the form of faster capital recovery, cut back the cost of payroll taxes, and help strengthen the administration's efforts to restrain wage and price increases.

STRUCTURE FOR A TAX CUT

To further these objectives, a $30 billion tax cut might be structured along the following lines. First, offset the scheduled 1981 increase in social security tax liabilties, preferably by direct action to cancel such increases, coupling this move with a shift of medicare hospital insurance costs to the general revenues, thereby protecting the integrity of the Social Security system. This would forestall a boost in business costs that is bound to put upward pressure on prices, as these costs of the additional payroll taxes are passed through to consumer prices, and it would forestall a cut in take-home pay that will lead to higher wage demands.

Now, if misplaced public fears about the soundness of the social security system prevent a direct cut in payroll taxes, the Gephardt approach of casting the cut in the form of a credit against income taxes for payroll taxes paid would be a second-best approach.

Second, devote $5 to $7 billion to the first-year costs of a carefully designed program of accelerated depreciation. The 10–5–3 plan unfortunately is not only too expensive, but would provide an undue and unnecessary stimulus to commercial building that will contribute very little to the country's reindustrialization.

Three, set aside another $5 billion or so for real wage insurance to buttress the voluntary wage-price restraint program. I realize that the greatest constituency for that is professors rather than Congressmen, but I still think it deserves serious consideration.

Now, such a program would have a four-ply anti-inflationary effect. First, holding employers' payroll taxes in check would curb cost and price increases. Second, curbing business costs and cuts in take-home pay would strengthen the Government's appeal to business and labor to stay within the voluntary guidelines. Third, real wage insurance would buttress that. And, fourth, easing of depreciation allowances would be a significant incentive for the increases in business investment and productivity that can help curb inflation in the longer run.

Although it may not be possible to complete action on such a program in 1980, I think one should seriously consider suspending or postponing that big wallop of payroll tax increases on January 1. Those increases will retard recovery and worsen inflation. They could be suspended or postponed until Congress has had a chance to enact a permanent tax cut. And if the action could be coupled with a firm and convincing pledge to make up the lost taxes from the general revenue, the economy would reap sizable benefits.

Now, I fully understand that it would be vital to take steps to relieve the deep concern, the anxiety, the alarm, even, about the soundness and safety of the social security system that have been raised by the headlines and stories that greatly overstate the problems of that system. I think any of us who give public speeches around the country know, from the question and answer periods, that many people are desperately worried that, somehow or another, their social security benefits are not going to be paid.

Now, the question may be raised, "Why so modest a cut in the light of the compelling case for such cuts?" And the answer is to be found in the facts of fiscal life. The built-in civilian spending increases plus the defense buildup require us to keep our tax powder dry.

One even hears stories around this town that a cold turkey look at the budget for the next few years sees it rising to 23, 24 percent of GNP, not falling. So we had better be very careful with the amount of tax cutting we do.

CONSERVATIVE TAX CUT BEST APPROACH

So the conservative and prudent course (which is the one I always, of course, follow), is to hold the tax cut to roughly $30 billion, and retain the rest of the revenue raising power of our tax system to serve the dual purpose of (a) permitting rapid progress toward a balanced budget as the economy recovers, and (b) enabling the monetary authorities to pursue a policy that will be somewhat less restrictive, and, hence, somewhat more favorable to investment.

Finally, this is in sharp contrast to the tax cut program of the fiscal radicals who want a $36 billion downpayment on a tax cut that would cost over $250 billion by 1985, at the same time that they advocate a $100 billion increase in defense expenditures. That kind of tax cut might win votes, but it would lose the war against inflation.

PREPARED STATEMENT OF WALTER W. HELLER, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

To appear before the Senate Budget Committee, which plays such a vital role not only in budget policy but in overall economic policy, is always a privilege and a challenge. With the economy, inflation, the budget, tax policy, and politics all in an advanced state of flux—"up for grabs" might be a better way of putting it—the challenge is a particularly demanding one.

THE COURSE OF THE ECONOMY

How bad will the recession be, and how long will it last? That question, though too narrow, is a good point of departure for appraising the role of fiscal policy. The best bet now is that recession will run its course by the end of the year and then turn into a moderate recovery in 1981. That means, by the way, that the recession as such is pretty much beyond redemption by policy changes in 1980. Even if Congress could enact a tax cut in the remaining "40 shopping days until Christmas," that is, the working days left on the 1980 Congressional calendar, the tax cut would have little impact on this year's economy. And with Federal Reserve policy locked in on its modest money growth targets (I say this without the benefit, as yet, of the new testimony by Chairman Volcker), we should expect relatively little change in the 1980 recession outlook from the monetary side.

The main economic thrust of tax, budgetary, and monetary policy, then, will be on the pace of recovery and the prospects for growth and inflation in the 1980s. And there, as I will duscuss later, fiscal policy—and especially tax policy—has a key role to play.

FORCES THAT MADE A RECESSION INEVITABLE

In thinking about the recession, we should remind ourselves of the forces that made it inevitable:

An "oil drag" that will by the end of this year be siphoning about $80 billion more a year of purchasing power out of consumers' pockets than it was two years earlier;

A "fiscal drag" reflected in the swing from a high-employment deficit of about $25 billion in 1978 to a high-employment surplus of about $60 billion in 1981 (using 6 percent unemployment as the benchmark for high employment);

A "monetary drag" highlighted by the Federal Reserve's credit clampdowns last October and again in March.

Economists missed the call on the timing of the recession, but to many if not most of us, its eventual appearance under the triple whammy of the oil, fiscal, and monetary drags was never in doubt.

REAL GROWTH OF GNP

The 1980 recession is a curious combination of severity and self-limiting forces:

In spite of the steep slide in the second quarter, there are no signs that the bottom is about to drop out. A reasonable forecast would be an overall drop of 4 percent to 4½ percent in real GNP between peak and trough, with recovery starting around the turn of the year. Then, even a very modest recovery (relative to the average of nearly 7 percent real GNP growth in the four quarters after the troughs of the six previous post-war recessions) should carry GNP upward at a 3 percent to 4 percent pace in 1981—3 percent without and 4 percent with a tax cut.

Qualitatively, the recession is distressing but not disorderly. Distress is the order of the day for the unemployed, the overburdened consumer, the whipsawed small businessman and farmer, and the soggy auto industry. But there has been no panic in either the financial markets or the consumer or producer sectors.

Although consumers have taken a severe drubbing reflected in the dizzying drop of consumer spending in the second quarter, both consumer confidence and retail sales have been steadying, and consumer debt formation has been cut dramatically.

In the producer sector, there is no general liquidity crisis, business has been doing a remarkable job of cutting back inventories as sales sag, and there is no wholesale slashing of capital spending plans.

In relation to our premature forecasts of recession in 1979, one would like to think that our cries of "wolf" led businessmen—and to some extent, consumers—to erect defenses to cope with the beast when it appeared at their door. In any event, barring an adverse turn of events, the recession should run its course this year.

This does not rule out an increase of unemployment into early 1981. I would expect it to reach a peak somewhat above the administration's new forecast of 8½ percent and then back off a bit during 1981, especially with the boost of a tax cut.

But as noted earlier, the 1980 recession is too narrow a context in which to consider budgetary and tax policy. In formulating economic strategy from here on out, and especially in structuring a tax cut, we have to broaden our perspective to embrace not just the recession in 1980, but the slowdown in 1979 and the restrained recovery in 1981.

OUTPUT GAPS AND COSTS

Putting the demand side of a possible tax cut into this broader context reveals that there is plenty of head room for expansion and no danger of triggering renewed demand inflation from a moderate tax cut, of, say, $30 billion. Before citing the numbers that lead to this conclusion, one should look back to note that expansion slowed to a crawl in 1979: fourth quarter real GNP (1972 prices) in 1979 was only 1 percent above real GNP in the fourth quarter of 1978. In other words, we were already falling behind the economy's capabilities last year.

Looking ahead: even under the moderate assumption of a 4 percent drop in real GNP between the fourth quarters of 1979 and 1980 and the optimistic assumption of a 4 percent rise in real GNP between the fourth quarters of 1980 and 1981, the U.S. economy will not achieve its late-1978 levels of output until 1981. In the determined effort to retard inflation, we will have given up three years' growth.

The next step is to quantify that foregone growth and estimate how much room we have for expansion of output before the economy starts bumping against its productive capacity or potential.

In the Economic Report of the President last January, The Council of Economic Advisers reduced its estimate of the growth rate of potential GNP for 1979–81 from 3 percent to 2½ percent a year. This consisted of a 1½ percent annual growth in labor input and a trend increase in productivity of about 1 percent per year.

Starting with the fourth quarter of 1978, one finds that, at a 2½ percent annual growth rate, the U.S. economy could have produced (in 1972 prices, at annual rates) $1,480 billion of GNP against an actual output of roughly $1,410 billion, leaving a gap of $70 billion. In today's prices, that's a gap of $125 billion. Under the impact of recession, this gap will grow to $115 billion in 1972 prices or $200 billion in today's prices, by the end of 1980. Modest recovery will gradually shrink this gap to $100 billion in 1972 prices or $170 billion in today's prices by the end of 1981. The point of the exercise is clear: even with a tax cut of $30 billion, we would not come within a country mile of pressing against the economy's ceilings.

To meet the possible objections of those who believe that the miserable performance of productivity in recent years calls for an even lower figure for the growth in GNP potential than the CEA's 2½ percent, I have made an alternative calculation at a 2 percent annual growth rate for GNP potential, i.e., a 1½ percent increase in labor input and a ½ percent increase in productivity per year. (One might note in passing that this is just half of the growth rate of the mid-1960's.)

On this basis, the gap between actual and potential output was $60 billion in 1972 prices or $108 billion in today's prices in the second quarter of this year. It will expand to $100 billion in 1972 prices and $180 billion in today's prices by the fourth quarter of this year and then gradually shrink to $75 billion in 1972 prices and $133 billion in today's prices by the end of 1981.

These calculations tell us first, that in today's prices, actual output on January 1, 1981—the most widely discussed target date for putting a tax cut into effect—would be running about $180 billion below potential (even on the conservative assumptions of 2 percent growth in potential and a 4 percent recession), leaving a wide margin of safety for non-inflationary tax cuts. But, second, they tell us more than that: at the very modest growth rate of 2 percent in GNP potential, the economy would have produced $300 billion more (in today's prices) than it actually will produce in three years of slowdown, recession, and sluggish recovery. The costs of fighting inflation by monetary-fiscal restriction are high indeed.

THE INFLATION OUTLOOK

What are we buying for this huge loss in output and jobs? What benefits can we look for in reduced inflation?

On the surface, the answer seems impressive: the consumer price index will drop from its peak of 18 percent in the first quarter of this year to a trough of perhaps 6 percent late in the year before rising food prices and interest rates again push it upwards. Most of the drop is simply a case of letting the air out of the CPI as the artificial bubble created by sky-rocketing mortgage interest rates and housing prices is deflated and as we benefit from the let-up in OPEC price boosts.

But as this Committee is painfully aware, what lies beneath the surface—the hardcore or bedrock or underlying rate of inflation—will budge very little under the pressures of economic slowdown. The rigors of recession are translating mainly into layoffs and production cutbacks, not into lower wage and price increases. Catch-up is still the name of the game in a large part of the labor force: non-union wages are catching up with union wages, and overall wage increases are trying to make up this year for the gap that opened up between price and pay increases last year.

At the same time, although there is some price cutting and discounting, discouraging evidence of price hikes in the teeth of falling sales abounds in today's recession. When General Motors boosts prices of its average car by $135 in an "undaunted effort to pass on to consumers a large chunk of its increased production costs" even in the face of the weakest auto markets in recent memory, one is moved to ask: "Recession, where is thy anti-inflationary sting?" Indeed, a major manufacturer was quoted recently as saying "we had to raise our prices to make up for the loss of volume." Whatever happened to the "rigors of the market place?"

Undoubtedly, the recession and widespread slack in the economy will have some moderating effect on price and wage increases. But even at that, it seems unlikely that the rise in average hourly compensation will be cut much below 9½ percent a year by the time recession has run its course. And given a trend increase in productivity these days of less than 1 percent a year, unit labor costs will be rising 8½ percent or more. This will set a virtual floor of between 8 percent and 9 percent under our hardcore inflation rate as we enter the next expansion. In other words, we will come out of this recession with the inflationary gases vented, but the glowing bedrock of inflation will recede little if at all and will threaten to erupt again when recovery is in full swing.

All the measures on which anti-inflationary rhetoric thrives—cutting government regulatory costs, eliminating unnecessary federal spending, and maintaining monetary discipline (all of which are necessary) may take some of the edge off of inflation. But unless and until we relieve the relentless force of cost pressures, the prospects for getting inflation back to the 3 percent to 5 percent range are bleak. If, in the absence of an effective voluntary wage-price restraint program—preferably backed up by effective tax incentives—a return to economic prosperity in the '80s brings with it renewed double-digit inflation and then some, we will be heading directly for mandatory controls.

THE BUDGET IN PERSPECTIVE

One needs not just bifocals but trifocals these days to get a balanced reading of federal budgetary developments as they affect the economy.

First, a closeup view of just the absolute numbers provides a rather disturbing picture. One need only cite the growth of federal budget spending in the current fiscal year from the President's original proposal of $531 billion to a present projection of $580 billion—with a $61 billion deficit attached—to underscore the point. No matter how much better the budget may look through other lenses, a boost of nearly $50 billion in this year's expenditures between the time of conception and the time of delivery cannot be deemed tight budgetary control.

But looking through that middle lens, the perspective does improve considerably:

This year's budget labors did produce a budget that, leaving tax cuts aside, would have come close to balance under the working assumptions of a mild recession and unemployment peaking at 7.5 percent and would have produced an impressive surplus in the absence of recession. That actual deficit of $30 to $40 billion we now face, even in the absence of a tax cut, is a normal outgrowth of recession and slow growth. It threatens no inflationary thrust or crowding-out of private borrowing. The Treasury's borrowing needs will be largely a mirror image of shrunken private borrowing requirements.

Still looking through the middle lens, one finds, surprisingly, that even with the defense buildup, 1981 budget outlays will be somewhat smaller in real terms than 1980 outlays. Combing out the increase in non-defense spending leaves a cutback in real non-defense spending between 3 percent and 5 percent.

Looking through the broadest lens so as to encompass not just spending but taxes, we can get a fix on the full impact of fiscal policy in the course of recession and recovery. This view reveals that we are in a sharp swing toward fiscal restriction. Because tax revenues are trending upward much more rapidly than federal expenditures, the budget, as already noted, is making an $85 billion swing from stimulus toward restriction between 1978 and 1981. Most of this restrictive swing—as much as $60 billion—will occur between fiscal 1980 and fiscal 1981. So an escalating fiscal drag still lies dead ahead.

THE COMPELLING CASE FOR A TAX CUT

Against the foregoing economic and fiscal background, we can now sum up the cause for action on the tax front. The following facts confront us:

First, there is plenty of slack in the economy as purchasing power and final sales plunge while our capacity to produce keeps rising.

Second, inflation has been stealthily boosting our personal income taxes, moving them from 21 percent of personal income of 1978 to 22 percent this year, heading for nearly 23 percent next year. At the same time, overall taxes have pushed to a new high of around 22 percent of GNP.

Third, $18 billion of new payroll taxes and a mounting tide of oil profits taxes are coming onstream next year.

Fourth, primarily as a result of these huge tax increases, but partly as a function of expenditure restraint for 1981, fiscal policy is swinging hard toward restriction in the face of recession, an almost unprecedented policy circumstance.

Fifth, properly structured, tax cuts can not only remove some of the fiscal overburden that will unduly retard recovery in 1981 but serve as an important weapon in the battle for higher productivity and lower inflation.

In light of these realities, we could stand a tax cut tomorrow if it were possible to wave a magic wand and produce a balanced pro-growth and anti-inflationary tax program overnight. But I agree with the Administration that under the pressures of an election year and given the limitations of the Congressional calendar, this is simply not possible. It is much the better part of wisdom to hammer out a carefully designed tax cut that will advance rather than retard our basic economic objectives.

But I disagree with the aministration in its unwillingness to make a firm pledge of a 1981 tax cut and in thereby suggesting that no action should be taken in 1980.

Clearly, it is too late in the day for a tax cut in 1980. But it is none too late to move on a carefully crafted tax reduction for early 1981 that will remove some of the fiscal drag, offer business tax incentives in the form of faster capital recovery, cut back the cost of payroll taxes, and help strengthen the Administration's efforts to restrain wage and price increases.

To further these objectives, a $30 billion tax cut might be structured along the following lines:

Offset the scheduled 1981 increase of $18 billion in social security tax liabilities, preferably by direct action to cancel such increases, coupling this move with a shift of Medicare hospital insurance costs to the general revenues, thereby protecting the integrity of the social security system. This would forestall a boost in business costs that is bound to put upward pressure on prices as these costs are passed through to consumer prices. It would also forestall a cut in take-home pay that will lead to higher wage demands. If misplaced public fears about the soundness of the social security system prevents a direct cut in payroll taxes, the Gephardt approach of casting the cut in the form of a credit against income taxes for payroll taxes paid would be a second-best approach.

Devote $5 to $7 billion to the first-year costs of a carefully designed program of accelerated depreciation. The 10–5–3 plan is not only too expensive, but would provide an undue and unnecessary stimulus to commercial building that will contribute little to the country's "reindustrialization."

Set aside another $5 billion or so for real wage insurance to bulwark the voluntary wage-price restraint program.

Such a program would have a four-ply anti-inflationary impact. First, by holding employers' payroll taxes in check, it would curb price increases. Second, the curbing of business costs and cuts in take-home pay would strengthen the government's appeal to business and labor to stay within the voluntary guidelines. Third, real wage insurance would be an important inducement to labor to comply with the guidelines. Fourth, easing of depreciation allowances would be a significant incentive for the increases in business investment and productivity that can help curb inflation in the longer run.

Although it may not be possible to complete action on such a program in 1980, serious consideration should be given to suspending or postponing the payroll tax increase on January 1. That increase will retard recovery and worsen inflation. If it could be suspended or postponed until Congress has had a chance to enact a permanent tax cut, and if the action could be coupled with a firm and convincing pledge to make up the lost taxes from the general revenue, the economy would reap sizeable benefits. I fully understand that it would be vital to take steps to relieve the deep concern, even anxiety and alarm, about the soundness and safety of the social security system that have been raised by headlines and stories greatly overstating the problems of that system.

The question may be raised: Why so modest a tax cut in the light of the compelling case for such cuts? The answer is to be found in the facts of fiscal life: the built-in civilian increases plus the defense buildup require us to keep our tax powder dry. The conservative and prudent course is to hold the tax cut to roughly $30 billion and retain the rest of the revenue-raising power of our tax system to serve the dual purpose of permitting rapid progress toward a balanced budget as the economy recovers and enabling the monetary authorities to pursue a policy that will be somewhat less restrictive and hence somewhat more favorable to investment.

This is in sharp contrast to the tax-cut program of the fiscal radicals who want a $36 billion downpayment on a tax cut that would cost over $200 billion by 1984, at the same time that they advocate a $100 billion increase in defense expenditures. That kind of a tax cut might win votes, but it would lose the war against inflation.

Chairman HOLLINGS. Thank you very much, Dr. Heller.

We are going to have to break for five bells for a roll call. So rather than break in, we will take a recess now.

[Whereupon, a short recess was taken.]

TARGET TAX CUT PROGRAMS

Chairman HOLLINGS. Dr. Heller, while we are waiting for the other Senators to come back, how do you make that whole program confineable, where it does not lose too much and does not go to people who anyway would not have enjoyed any kind of pay increases than otherwise.

I mean, I just never have seen politically and economically the "what if we had done it." You can look back now and see that the inflation and a lot of the increases and everything else went way above.

It would have cost more than the original amount of some, what did they put, $12 billion aside? I do not know how much——

Dr. HELLER. I thought it was a good deal less than that.

Chairman HOLLINGS. Maybe that is the figure, then. It would have had that kind of exposure, a $12 billion exposure.

Dr. HELLER. They put a cap on it, as I recall, so that I thought it would not have gone that high.

Chairman HOLLINGS. Maybe I am wrong on that. But how do you cap it, confine it and how do you make it work?

Dr. HELLER. Well, you know, in principle, if you got that kind of insurance, got that kind of carrot to hold out, first of all, it would tend to restrain wage increase, because you only get the protection against inflation if you stay within the guideline, so that it has some self-limiting impact.

And second, I might say in the context of 1980 and 1981, we have much better prospects of staying within more reasonable inflationary bounds than, under the impact of housing costs, mortgage rates and OPEC it turned out we did in 1979 and the first half of 1980.

Sure it takes risks. You have got to put a cap on it, but I guess what it amounts to is that it becomes so desperately important in the longer run, if we are going to battle inflation successfully, it becomes so desperately important to get some kind of a mutual agreement of big labor and big business, in particular, to hold back their wage and price increases.

And to the extent that we can use the carrot of tax cuts, and since we have some tax cuts at our disposal, I would just like to allocate some of it to that purpose. As I said in my statement, if we do not make it next time around, suppose we start from a 9-percent, 8- to 9-percent bedrock base of inflation then get back toward full prosperity and inflation takes off again, I just think we are headed directly into mandatory controls unless we have done a fairly good job of some kind of mutually agreed restraint.

And that is a very, very tough political problem.

MANDATORY WAGE AND PRICE CONTROLS

Chairman HOLLINGS. Do you recommend mandatory controls at this time?

Dr. HELLER. No, I do not.

Chairman HOLLINGS. At what point would you recommend mandatory controls?

Dr. HELLER. I think if we sailed back into 12-, 14-, 15-percent inflation with no relief in sight, I would very, very likely break over into the shock treatment of inflation side by side with monetary and fiscal discipline and translate that monetary and fiscal discipline into lower wage and price increases, not so much into lost jobs and lost output.

If we cannot do it any other way, I would take a couple of years of mandatory price controls. I can make an airtight case against them, but sometimes high as the costs are, the costs of not doing something might be even higher.

I am not prepared to toss in the towel and say that we cannot do it and that we are inevitably headed for mandatory controls. We simply have to plug in the dangers of inflation all the way through as we formulate policy—tax policy, wage policy, regulatory policy, you name it.

Chairman HOLLINGS. All right. We have Senator Chiles and Senator Bellmon back now. So Dr. Greenspan, we would be glad to hear from you, sir, at this time.

Go ahead, sir.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Dr. GREENSPAN. Thank you, Mr. Chairman. I will purposely not, as I had planned to do, discuss some of the specific economic assumptions and the answers to the specific questions which you addressed to us mainly on the grounds that, while I do differ in certain minor respects from what Dr. Heller has outlined here earlier, they are, indeed, minor and I do not believe it is worth the committee's time to go into them.

I would assume, however, during the formal question period that I will have occasion to raise some minor qualifications with respect to his economic document.

Senator **CHILES**. Mr. Chairman, let me interrupt.

Do you mean to say that Greenspan and Heller are in agreement?

Dr. **GREENSPAN**. You will find that he is beginning to move to the right, and I am finding him ever more comfortable, Senator. [Laughter.]

Senator **CHILES**. I think the millennium has arrived.

Dr. **HELLER**. Do not misunderstand me. I am not prepared to accept that judgment out of hand. [Laughter.] But I am glad that Alan feels more comfortable. That in itself is worth something.

Dr. **GREENSPAN**. However, when you begin to realize that I am probably one of those fiscal radicals to which you referred, you are going to feel rather warm as you move in this direction. [Laughter.]

Chairman **HOLLINGS**. Go right ahead. Thank you.

BUDGET BALANCE THROUGH INCREASED TAXES WOULD STIFLE PRODUCTIVE SYSTEM

Dr. **GREENSPAN**. In any event, gentlemen, what I should like to focus on is this question of a tax cut and try to put it in a somewhat different context. It is essential that in our evaluation of the question of the tax cut that we segregate the primary from the secondary goals so that we do not achieve a secondary goal yet fail to achieve the primary purpose.

Our primary goal is a vital and growing economic system. The issues of inflation and budget balance are actually secondary. We wish to achieve budget balance or hopefully even surplus and defuse the underlying inflationary pressures in our economy in order to achieve the primary goal, that is, a vital economy.

If we achieve budget balance through a major increase in the tax burden, we will stifle our productive system. It is possible to imagine budget balance, but with such a high and growing proportion of incomes absorbed by taxation that productivity would fall.

Hence, those of us who support budget balance, and I have been doing so and will continue to do so, because I think it is critically important, implicitly require that the balance be achieved by reining in spending, preferably in the context of lower taxation generally.

BRACKET CREEP INCREASES REAL TAX BURDEN

Increasing real tax rates would undercut incentives and produce stagnation. This process becomes especially pernicious during periods of inflation. At such times, "bracket creep", as it is now so elegantly called, increases the real tax burden of the average American family.

A family whose real average monthly pretax income rises only in line with inflation gets taxed at a higher tax rate producing a decline in real after-tax purchasing power. The family's tax burden has risen without legislation.

Corporations face a similar problem as you know with effective tax rates rising as a percent of pretax corporate profits adjusted for replacement cost. The inflation tax must be curbed if we are to restore growth to our economy.

The tax problem over the next several years is exacerbated by the onset of the large drain of funds from the windfall profits tax and the increase in social security taxes. As a result, Federal revenues are scheduled to rise in excess of $86 billion dollars from fiscal 1980 to 1981, even though recession will cut into next year's tax receipts. A marked increase in the proportion of Federal revenues to GNP for fiscal 1981 is implied.

From the current services budget, further increases are evident, and as I recall between fiscal 1979 and 1985, we are talking something like 5 percentage point increase in revenues as a percent of GNP.

This is the appropriate context for evaluating the Congressional Republican tax proposal initiative, joined by Governor Reagan, which requests Congress to pass a 10 percent cut in individual income taxes and make a start on removing the inflation bias from corporate taxation. They are recommending paring only part of the aggregate increase in taxation schedule for next year.

We must focus on achieving budget balance, but in the context of lower tax rates. This requires a double-pronged effort to keep the trend of expenditures down while gradually removing inflation collections from our tax system.

This can be achieved, first, by simulating indexing through a series of programmed tax cuts and later by locking in an indexing system to avoid a resurgence of the inflation tax problem over the longer run.

EXPENDITURE GROWTH NECESSITATES CHANGE IN FISCAL PROCEDURES

It is becoming increasingly apparent that getting the longer run growth in expenditures on track with a stable or gradually lowering rate of taxation will require a change in our flawed fiscal procedures.

Benefit program entitlements have been rising at a rate twice the growth of the GNP. We have finally come to the point where the divergence between new Federal program creation and tax base growth cannot continue without bringing the American economy to its knees.

Fortunately, we have not, as yet, arrived at a state where significant changes in existing programs are required in order to bring the trend of Federal expenditures back on track, although there are surely many desirable areas for change and curtailment.

If we could be assured that Federal outlays would rise in current dollar terms over the next 5 years solely in line with current law, that is, in line with the current services budget including discretionary inflation adjustments, we would have great leeway for increasing defense budgets and cutting taxes while still restoring ultimately a balanced budget.

AUTOMATIC ADD-ONS COMPOUND BUDGETARY PROBLEMS

The budgetary problems of the past have stemmed from a special type of seemingly automatic add-ons which have prevailed year after year, ratcheting the long-term trend of federal outlays ever upward. This results from the fact that every year the Congress adds new programs and increased benefits to the existing body of entitlements.

The mere fact that the Congress meets for a full legislative year, to pass expensive legislation, insures an automatic add-on to the long-term Federal budget. One can forecast this normal add-on without any advertance to the substance of the types of programs considered by the Congress or the needs of the Nation. It occurs solely because the Congress meets virtually all year long and passes new bills with reasonably forecastable price tags on them.

REQUIRE SUPER MAJORITY VOTE FOR MONEY BILLS

I thus conclude, only half facetiously, that a major effective program of fiscal restraint would be for the Congress to be sent home 6 months a year to visit with their constituents at time and a half, hopefully. This would be an exceptionally profitable investment for the average taxpayer.

However, short of a major change in our legislative procedures, I have reluctantly concluded that a reestablishing of fiscal restraint can be accomplished only through a constitutional amendment.

Amendments to balance the budget seek the right remedies to the political weakness underlying our fiscal system, but they would be very difficult to implement. Restraints on expenditures by some formula tied to other economic variables also raise technical difficulties. In any event, the desired end of both balanced budget and expenditure limitation amendments can be met by requiring super majorities in the Congress to pass a money bill.

For example, if 60 percent of both houses of the Congress were required to pass any authorization, appropriation, expenditure, or credit guarantee bill, the underlying tendency to overcommit fiscal resources would be severely restricted. Such a procedure would avoid many of the problems associated with defining an appropriate balanced budget, or expenditure limitation constitutional amendment.

Pending the passage of a constitutional amendment requiring a three-fifths vote on money bills, we might wisely amend the Budget Act of 1974 in a similar fashion. While the three-fifths vote requirement could be rescinded by a majority of the Congress with the acquiescence of the President, individual Congressmen might well be persuaded not to vote for such a recision since it might stamp them as less than fiscally responsible.

So there is a possibility that a legislative super majority requirement could indeed hold. It is doubtful that one could rely on that for an overly extended period. A constitutional amendment mandating such a requirement appears to be the only viable, long-term solution.

Having looked at the fiscal 1980 and 1981 process in considerable detail, in the context of very severe and, I think, very formidable efforts by the Congress to restrain the budget and restore budget balance, I have become increasingly concerned that what we are dealing with is something which is tantamount to a spending juggernaut. It seems to be ripping through us in a manner which we cannot control.

I recently looked at some of the monthly data that my organization keeps on unified budget receipts and expenditures, seasonally adjusted, broken down by different elements, and have just recently become rather concerned that after a protracted period of relatively stable growth in outlays, in recent months outlay growth has turned upward.

And that leads me to conclude that, while we may find the fiscal 1980 estimates shocking, those that are coming out of OMB, I find it is very easy to get to a $61 billion budget deficit.

My major concern is that when we close the books after September 30 that the number could be quite a good deal higher than that. It is beginning to dawn on those of us who watch this process quite extensively that far more intensive efforts are going to be required to restrain outlays.

This is all the more important in the context of what I have stated in my formal testimony; namely, that I am also concerned that we are allowing taxes to go up too rapidly.

So I conclude as my bottom line that the problems that we are dealing with in the budget are larger than we imagine and perhaps will require far more formidable attempts at restraint than we have initiated to date.

Thank you.

ASSESSING INCREASED FEDERAL REVENUES

Chairman **Hollings**. Well, Dr. Greenspan, I think your two remedies was, one, to either send us home or the other one to amend the constitution so as to really require three-fifths before we could do anything.

As that 1980, you say, expenditures increased, it increased by some $16 billion in the last 30 days without any congressional actions. We were home. And it keeps going up, up and away.

We have got to have some other way to get at it. Let me see, so that we can be talking the same language, because I do not know that sometime the economists, and I am willing to be educated, but you folks talk rather glibly of tax increases, and I'm not voting for any of them, but then you say that is the way they are.

The $85 billion in Federal revenues, that increase that you talk about from fiscal 1980 to 1981, can you give us a quick breakdown? How do you arrive at that $86 billion?

Dr. **Greenspan**. Well, the simplest way may be to look at the latest budget figures. The question is where is it coming from. I would suspect about $15 billion is coming from what we call bracket creep. There is the obvious social security tax increase which is largely required because we have already mandated the entitlements on the expenditure side.

Chairman **Hollings**. So how much in social security? Fifteen on bracket creep——

Dr. **Greenspan**. Unfortunately, Mr. Chairman, I do not have the numbers immediately available, but I will certainly take a few minutes to recalculate them and I will be glad to make them available to you shortly after this is over.

BRACKET CREEP ONLY AFFECTS PAY INCREASE RECIPIENTS

Chairman **Hollings**. Well, we are going further trying to talk the same language. Now, for example, on bracket creep. You see, I am trying to understand exactly how that occurs, and that occurs with those who actually get increases in pay. So I do not get an increase in pay and I have got a lot of inflation so I have not been thrown up in any bracket creep. There is no bracket creep with anyone who is not getting a pay increase, is not that right?

Dr. **Greenspan**. That is correct, but when economists talk in terms of tax burden, they try to do it in real terms that is adjusted for inflation and try to focus on the question of purchasing power.

Chairman **Hollings**. I understand.

Dr. **Greenspan**. And so if you have no pay increase in a period of inflation, obviously, your purchasing power is falling. But what this bracket creep refers to very specifically are the individuals whose nominal incomes are rising with inflation, proportionately with inflation, but because their real pretax incomes are not rising——

Chairman **Hollings**. Right. I understand that.

Dr. **Greenspan** [continuing]. Their tax rates are. As a consequence the ratio of tax in real terms to income in real terms is rising with no change in standard of living, and in fact, in this particular example, an actual decline.

Chairman **Hollings**. But bracket creep applies to a minority of Americans?

Dr. **Greenspan**. No, on the contrary.

Chairman **Hollings**. A majority? A majority will get a pay increase?

Dr. **Greenspan**. No. I am saying it applies to the majority who, on average, have been getting nominal pay increases.

Chairman **Hollings**. Do not say "on average." I am talking about the body politic as a whole as I understood it.

Dr. **Greenspan**. Over a 2-year period, Senator, I would guess that an extremely high proportion of American workers have had significant nominal pay increases, and as a consequence, not all, but a significant proportion of those have had an increase in the ratio of their tax to their incomes.

Chairman **Hollings**. Well, I would like, if you would furnish later for the record, whether the majority of Americans really experienced an increase in pay or not, during an average year period.[1]

I have always thought, for example, when you were talking about the wage insurance, that is one of the difficulties with it in that we are talking about a minority of Americans, because the majority are not going to have that pay increase, not even going to get to the, let us say, 7-percent level as the administration was originally talking about. And I am trying to get these things fixed in my mind.

WINDFALL PROFITS TAX SETASIDES PREVENT TAX INCREASE

Let us think, second, then, of the windfall profits tax. Now, actually, that was taken from the oil companies, a portion of their windfall profits or put another way, half of it was set aside by way of intent for future tax reductions.

Now, assuming that if we did not have that windfall profits tax, we would have had to increase taxes. In other words, we talk right glibly and loosely that that is apparently a tax increase on the individual American really. That prevents a tax increase on individual Americans, does it not?

---

[1] Not received at time of printing.

Dr. Greenspan. I doubt it, Senator. It has been my impression over the years that, if money is there, there is a very strong tendency for it to be spent. And while I certainly do not deny that when pressures for increased expenditures occur, that they are met in part by increased taxation.

It has also been my experience that there is very strong restraint on the issue of increasing tax rates. And the other possibility is that, without those revenues, expenditure growth would probably be less.

PRE-ELECTION STIMULUS FOR UNEMPLOYMENT

Chairman Hollings. Of course, we are all talking about withstanding the impact of the payroll tax increases come the first of January for social security, and that was one of the setasides.

Let me ask with respect to unemployment and the same old conversation and consideration about stimulus. Here I have got all of these unemployed automobile workers and otherwise in America. It is 7.7 percent.

You folks say we are going to be nearer 8.8 percent or 8.9 percent come election day. Now, how can I sit still and do nothing? Or my question, what can I do between now and election day to forestall that unemployment? Is there any kind of stimulus program that you recommend?

UTILIZE JOB PROGRAMS TO COMBAT UNEMPLOYMENT

Dr. Heller. Well, in practical terms, as I was suggesting in my statement, it is extremely difficult to get much action between now and the end of the recession which most of us pitch at the fourth quarter, sometime in the fourth quarter of this year.

If I had my druthers, however, I would move on some jobs programs, some areas in the budget where you could move quickly to generate additional jobs. I do not think that the tax cut can be moved through nor do I think, for example, that easier money policy, at this stage of the game, is either very feasible or that it would have very much effect because of——

Chairman Hollings. What kind of jobs program would have an effect? I mean, we know that the public works kind of programs——

Dr. Heller. No, public works is not the way to go. All the studies have tended to show that.

Chairman Hollings. Right.

Dr. Heller. As you recall, our speedup of public works back in 1963, we finally finished that off in 1969 or something like that according to Nancy Teeter's study.

No, public works is not the way to go for antirecession purposes. It may be perfectly sound for other reasons, but not for antirecession purposes.

You would have to go the public service jobs route, some sort of public/private partnership to provide both jobs and training. Things that are already in train that you can beef up in a hurry.

Chairman Hollings. I will yield to you right after the vote.

[Whereupon, a short recess was taken.]

CURRENT RECESSION PRODUCED BY CHANGE IN MONETARY POLICY

Senator **Bellmon**. Senator Hollings has asked me to go ahead with the questions. I would like to try to get down to some specifics. We thought, when we worked on the first budget resolution that we were going to have a balanced budget for fiscal year 1981, something a lot of us have looked forward to for a long time.

And now because of changes in the economic projections, it appears that that is not possible. So let me start out by asking, I guess the question could be summed up by asking if this recession we seem to be in is really necessary. It was brought on, as I understand it, not by any change in fiscal policy but by a change in monetary policy. Is that right?

Dr. **Greenspan**. I would not quite conclude that, Senator. In my judgment, and I grant you that our understanding of this particular recessionary process is far from complete, its roots go back several years.

And while one can argue that ultimately what engendered this sharp decline was high interest rates, the high interest rates in turn are the result of excessive inflationary forces that have been built into our system. Those interest rates are merely reflective of the inflation process itself.

So while it is seemingly rather direct to focus on the particular March 14 episode with respect to the Federal Reserve as triggering the decline, my suspicion is that with or without that episode, you would have had a decline, perhaps somewhat different from the one we are looking at but surely we would have had a major economic retrenchment.

ROLE OF CREDIT GUARANTEE PROGRAMS IN CURRENT RECESSION

I would, therefore, conclude, that, in fact, it was fiscal policy, not in the terms that this committee has tended to deal, direct on-budget items, but largely, as I have testified before this committee in years past, because of the extraordinary proliferation of indirect claims on credit sources from the Federal system, mainly through the guarantee of various different types of instruments.

So that the aggregate amount of credit, because of the on-budget deficits, the not very large off-budget deficits, but mainly from the credit guarantee programs, has created excessive liquidity in our system which, in my judgment, inevitably led to the inflationary excesses which we have experienced in the last 2 or 3 years.

And that, in turn, made higher interest rates inevitable, and made the collapse in housing inevitable. And for reasons which are slightly obscure, housing almost invariably pulls the motor vehicle industry down with it. Therefore, I would look behind the monetary policy for the source of this recession and I would conclude that there was very little we could have done to avoid it, I think, as Walter said earlier.

And what, in my judgment, requires to be done at this point is to avoid creating the types of environment which induced this recession. In answer to a question you put to Dr. Heller, I think there is very little we can do to fend off this particular sharp rise in unemployment. I do think we can do many things to prevent this type of thing from happening again.

And there is where I think fiscal and monetary policy, specifically budgetary policy, most surely has to be directed.

ECONOMIC DRAGS THAT LED TO RECESSION

Dr. **Heller**. Senator Bellmon, on the first part of Alan Greenspan's answer, I do have a substantial amount of disagreement in emphasis. It does seem to me that—before you came in, I went through the three drags on the economy that have so much to do with the recession.

It seems to me that, when, in a 2-year period, December of 1978 to December of 1980, you step up the price of oil to the point where it is syphoning, sucking actually $80 billion a year net more out of our pockets, a lot of that is a real income loss to the OPEC countries. Some of it stays in this country but does not come back into the economy from the oil industry. When you are pulling that much out of the economy, that much out of consumer pockets, that certainly is a recessionary force that does not find its origin in any kind of Government action.

Of course, the taking off of oil price ceilings, that is part of it this year, but it is far from the major part of it. Second, tax revenues have been rising faster than expenditures. That has been a drain on the economy.

And third, there is no doubt that the tightening monetary policy, and particularly the October 6 and March 14 moves—I agree with Alan that the March 14 thing was more of a trigger than a cause, but tightening monetary policy was a cause.

So I would not lay quite as much of the blame on, say, Federal credit activities as my esteemed colleague would.

Senator **Bellmon**. Well, had there been no tightening of monetary policy by the Fed, would we now be in a recession?

Dr. **Greenspan**. I think we would, and we would also be having greater inflation.

Dr. **Heller**. I would agree with that.

Dr. **Greenspan**. Now, I think we would have been in a recession. It would not have been as severe, but I do not think we could have avoided recession just by a somewhat easier Federal Reserve policy in this case, but I think we would have had higher inflation.

MONETARY REMEDIES COULD INCREASE INFLATION

Senator **Bellmon**. Well, now is there a monetary remedy for inflation? What we are going to face now here in Congress will be a spate of fiscal remedies for inflation, and if the Fed, at the same time, is bringing to the front monetary remedies, then it seems to me we are very likely to overstimulate the economy and within a period of months be right back with 20 percent inflation again.

Dr. **Heller**. Well, that is a danger, but, you know, I do not think that is a clear and present danger. My belief is that, with the Congress—perhaps I have more faith in the budgetary process, the new, the relatively new 5-year-old congressional budgetary process than a lot of people do, but with that budgetary process in place, with the greater responsiveness to the general public clamor for holding Government in check and with the Federal Reserve pretty well dedicated to holding the reins fairly tight in order to protect the dollar and in order to avoid a resurgence of inflation, I doubt that you are going to run into an overly stimulative policy in 1981.

That is one of the reasons almost everybody is forecasting a pretty modest recovery in 1981, because we do not think we are going to throw caution to the winds and open the spigots and pump up the economy.

Chairman HOLLINGS. Senator Chiles.

FEDERAL ASSISTANCE TO WEAKENING INDUSTRIES

Senator CHILES. I was, this morning, trying to question some of our panel about the problems that we see coming up in steel and the auto industry, and if we are talking about a tax cut for business, can we afford to have that just be a tax cut, you know, across-the-board for business, so to speak or do we need to pay some particular attention to how we are going to reindustrialize steel and some of our other heavy industry that appears to be so antiquated in their plants now?

Dr. HELLER. Let me just plainly confess that I am very much torn on this issue. I share your concern about the fact that the problems of American industry are not monolithic. They vary tremendously according to industry and according to area.

The sunbelt, in this case California and New England with defense industries and with technological industries and so forth are not going to be hurt as badly by the recession as many others whereas obviously steel and autos and housing have been taking a great drubbing.

And my point of being torn is that I was very much attracted partly by the Reconstruction Finance Corporation approach because of some of the great things it accomplished, and partly by the experience we had in the Korean War when we used certificates of convenience and necessity and gave 5-year amortization to those industries that were deemed to be important to that war effort and to the defense effort.

And I think that, while it has a lot of capacity for abuse, I think that worked reasonably well. What one worries about is the uses and abuses of discretionary authority.

Taxes, for example, accelerated depreciation. There are several ways you can do about that.

You can go 10–5–3 and nail it down, and that is the way it is. Or you could have groups of categories with different depreciation rates and you would speed up some and hold back others depending on which industries needed the most help.

But the dangers are, first of all, are you just going to rescue failing industries or are you going to place your bets on some of the innovative industries that could really reindustrialize this country or at least lead it to technological leadership.

Second, what about the frailties of human beings in making these decisions?

Senator CHILES. Well, when you say "failing industries," steel is failing. Automobiles are failing. If we said we were just going to pick our winners, you know, as that cliche goes, you let them fail. We cannot afford to do that.

Dr. HELLER. I am not suggesting that. All I am suggesting is that we would want to have a reasonable balance, it seems to me, between support for heavy industry that we regard as basic to the economy and the more innovative things where we could lead the way down new paths.

I am about at the point where I am willing to take the risk on the possible boners that might be made, possible uses of influence and lobbying and so forth that might be exerted on the Congress.

I recognize all those things, and yet your point about deploying the available tax leeway in the most effective way to accomplish these objectives, I think, is well taken. And so while I have not signed off on one plan or the other, and I just have to admit to equivocating on it, I am more and more attracted by some kind of a system that would differentiate in spite of the risks that you run when you differentiate.

UNITED KINGDOM ASSISTANCE TO INADEQUATE INDUSTRIES REGRETTED

Dr. **Greenspan**. Senator, we often forget how quickly times change. Steel was doing very well a few years back, so was autos. And frankly, I would expect both to do rather well some time in the future.

When you begin to endeavor to calibrate tax policy to a specific, definable, current concrete problem, there is a reasonably good chance that you will finally resolve the problem precisely when a solution is no longer needed.

If not, you are dealing often with cases which probably would be best allowed to gradually unwind. The extreme version of this process of endeavoring to reindustrialize largely through trying to shore up inadequate industry, obviously, is the United Kingdom. Their policy led them to an extremely deficient economic system, moribund capital and regrets of significant dimension.

Senator **Chiles**. I missed the first. What was the example?

Dr. **Greenspan**. The United Kingdom. In other words, they ended up with an extremely unfortunate state of affairs. Now, I am not saying that one should not look very closely at the various elements involved, and I would surely say that one should endeavor, where possible, to try to ask where, how and in what manner the Federal policies themselves may be contributing to the difficulties and see whether they can be altered.

But I would be extremely careful about starting down this road because any major endeavor to allocate capital largely to less than efficient industries, companies and the like has an inevitable end to it. And that is zero growth, zero productivity improvement, and a very difficult problem for the economy as a whole.

So while I would suggest that one look very closely, there are very major negatives in this approach which I do not think have been appropriately or fully explored as yet, but I do expect that they will be, should this issue surface.

I myself hope that in the automotive industry that the major initiatives that have been taken on the small car will, in fact, succeed. If so, it will make much of this discussion for that industry moot.

Senator **Chiles**. I certainly hope so, too.

Dr. **Greenspan**. I suggest, in any event, that you surely, at least, wait until that hypothesis is tested.

Dr. **Heller**. The only thing I would add, Senator, is that if we adopt a particular formula, 10-5-3, for example, we are also making decisions about the distribution, only we are making them arbitrarily, about the distribution of the tax benefits or largesse or stimulus or incentive or call it what you will.

A 10-5-3, you know, by lowering the useful lives of commercial buildings and shopping centers and so forth to 10 years, which is an enormous tax break, does not exactly contribute a lot to the reindustrialization of America.

As an old public finance functionary, I kind of back away from specific tax incentives of this kind because of their possible distortions, but when one compares the two approaches, one has to remember that any rigid formula also has its deficiencies and tends to do a lot of things with our tax dollars that are not optimal from the standpoint of what we are trying to achieve in the country.

That is why I am a little more open-minded about that, perhaps, than Alan.

POLICY TO HEAD OFF INDUSTRIAL DISASTERS

Senator **Chiles**. Well, I think that is one of the things that started concerning me, and I do not know that much about steel now. But some of the things I have been reading do not look too good, and it does not look like steel can rebound in a couple of years, you know, the plants are so antiquated, and the new capital is so horrendous, the amount of capital that they are going to have to raise, and the question is, you know, how are they going to be able to do that.

Now, I am concerned that we do not go in and bail an industry or a company, but what I am trying to do is get us away from the situations where we have a Chrysler come to us, you know, a U.S. Steel come to us or someone come on a basis like that and try to see if we can get out in front, if this is something that is in the national interest that we have to do something about major industries like autos and steel which have been such a major part of our economy and the strength of our economy, and I do not think we are ready to say they are losers and we just turn them over to Germany or Japan, that we just let them go.

So I am trying to think, if you start to do something, how do you go about it so that you see you have some management and labor compact, that it is not going to be windfalls for the stockholders, you know, that you are really doing something that is going to be more beneficial to the country or as beneficial to the country as well as strengthening those industries.

Again, I am concerned about 10-5-3, if you are just going to build the shopping centers quicker and what that cost you.

Dr. **Greenspan**. Senator, I think the first thing we have to focus on is that the steel industry is not a homogeneous group. There are, in fact, tremendously different elements of competition and efficiency in the American steel industry amongst various different types of products, different types of plants, different regions. Because we have a huge industry which we put under a single standard industrial classification, we all believe it is one industry.

There is a lot of, I am sure, dead wood in that industry. I have been through some of those plants which are really obsolete and understandably have great difficulty competing.

There are others which are doing rather well and I might finally say that how they look is not necessarily how efficient they are. Some of the most extraordinarily decrepit operations that I have seen are really quite efficient. One does not ordinarily determine that merely by looking at how shiny the steel plant is.

In fact, I would venture to say a shiny steel plant has few orders and probably is doing a terrible job.

Chairman **HOLLINGS**. Senator Domenici.

FEASIBILITY OF PLACING BINDING CEILING ON EXPENDITURES

Senator **DOMENICI**. Mr. Chairman, I have a number of questions, and if I go too long, would you stop me and I will let someone else question.

Let me ask you, Dr. Greenspan, I think you know that this Senator favors many of the ideas you have expressed in terms of putting some kind of binding ceilinq on our expenditures and the like, including requiring an extraordinary vote if you are going to break the budget or exceed a limit.

But I think today we find ourselves with a good opportunity to talk to you a little bit about whether that will work. What if we had a second concurrent binding proposition that you could not exceed, could not unbalance the budget after that second concurrent resolution, and what if that happened between the first and second occurred anyway, who do we put in jail?

Dr. **GREENSPAN**. That is exactly right, Senator, because if you have contradictory law, which is what you would have, I do not know what you do. If you have an entitlements program which specifies that a certain individual, if he meets certain requirements, is able to obtain a certain amount of food stamps or retirement income of one form or another, either social security or civil service or what-have-you, if you say in a binding resolution that you cannot pay those funds, what is the status of the law which, in fact, was originally passed which granted both authorization and appropriation.

Senator **DOMENICI**. So that, as a matter of fact, if you are going to have some kind of binding, and for binding I am going to use arbitrary, and I do not mean it in its bad sense, but arbitrary ceiling really you are going to have to have a major change in the legislation that is on the books or you will never be able to do anything more than what we did in the first concurrent resolution, which is to predict.

I mean, had the economic assumptions that we made lived for a few months, we would have been in balance. Had there been some economic breaks instead of some economic downturns, we would have been in balance.

Now, the same thing can happen after the second concurrent resolution. Under this process, we can have a balanced budget and then we can have an economic turndown, and we can end up with a $30 to $40 billion deficit, right?

Dr. **GREENSPAN**. Yes, sir.

DEFICIT NOT A RESULT OF NEW AUTHORIZATIONS

Senator **DOMENICI**. So those suggestions will not carry out the goal that you espouse unless something else happens with reference to the legislation that is presently on the books in the United States.

Second, you mentioned that Congress has enacted more and more new programs as if to say that the $29 billion deficit that is before us today, projected for 1981 instead of technical balance.

You seem to indicate that that was new laws, new entitlements, new authoriziations. My recollection is that there is not a single major new one in there, and we are $29 billion in deficit. Is that your recollection?

Dr. **GREENSPAN**. Yes, Senator, but what I am referring to is not the short term. What I am focusing on was the question as to why it is that we always find that the current services budget adjusted for discretionary inflation increments invariably shows a path well under where we actually finally end up. It is in the nature of a current services budget that, in real terms, it shows very little growth because essentially what you are doing is maintaining the existing entitlement structure.

Now, we know that that is not what has been happening. In fact, the proportion of Federal spending to GNP, for example, has been rising. We are dealing with a situation in which, there has not, in fact, been any really major new legislation passed by the Congress in recent years. That is very important. I would suspect it is probably the result of a major change in the attitude of the American people and the American Congress.

Senator **DOMENICI**. I agree.

NET EFFECT OF SMALL ADJUSTMENTS TO EXISTING PROGRAMS

Dr. **GREENSPAN**. My regret is that it has not been enough. What I am concerned about is that there is an extraordinarily large number of small adjustments to existing programs year after year, the net effect of which is substantial and additional.

If we somehow could shut off that flow, somehow prevent this small continuing incrementing to the program structure, we would make some very significant progress.

I also suspect that while we are dealing with the obvious desirability of maintaing restraint within the context of 1 or 2 fiscal years, the real restraint is budget authority, and that eventually must be viewed over a protracted period.

If there were a feasible way of delimiting the growth in budget authorities by some rule, you do not run into the obvious problem of the overrun, though Congress goes through this process, creates authorities, and with the exception of some minor adjustments that go on, that is it. It is behind you.

Senator **DOMENICI**. Well, you have been there. That is pretty hard to do in a $500 or $600 billion deficit with the number of programs we have, is it not?

Dr. **GREENSPAN**. It is exceptionally difficult. But I am beginning to wonder whether we can do it in any other way.

Senator **DOMENICI**. Well, it seems to me if you are going to try to have some limits that are binding, you are going to have to have some binding automatic cutbacks that occur spontaneously also or we will continue to have what we have been having. Is that what you are saying?

Dr. **Greenspan**. Yes, sir.

USE OF FISCAL AND MONETARY POLICY TO COMBAT UNEMPLOYMENT

Senator **Domenici**. Now let me ask both of you this question. With reference to unemployment, about 3½–4 years ago, there was a great deal of attention focused on the kind of unemployment we have. Some suggested that just macroeconomic policy would not have a significant impact on unemployment, because unemployment was heavily concentrated on the youth side, which would not necessarily respond.

It seems to me we have that in spades right now. It seems to me we have youth unemployment, and automobiles, steel and housing, the affected industries right now, and that housing is coming back. Am I correct in assuming that we still have a problem of the kind of unemployment that might not be as responsive as conventional economics might wish through fiscal and monetary policy or not?

Dr. **Heller**. I think there is a good deal to what you say. At the same time we should distinguish between those kinds of unemployment that are clearly secular, that are clearly the result of demographic movements and changes in women's participation and young people's participation in the labor force—and that kind will in considerable part be moderated just by demographic developments in the 1980's, as the big cohort that's that pig in the python, that is running through the python, as that gets digested in the labor force. As the postwar baby boom entrants in the labor force become more experienced—as they become more responsible, one hopes, less laid back, one hopes—that problem is in part going to take care of itself. We will have (I don't recall the exact numbers), some 12 million people entering the labor force this decade as against 21 million the preceding decade. I am sure those aren't the exact numbers, but the order of magnitude. That problem is in considerable part going to take care of itself over a longer period of time.

When you talk about automobile unemployment, I think there is a mixture. Some stimulus to overall purchasing power is obviously going to lead to people buying more cars. There are some limits to how many of those small cars they can produce—I know how long I waited for my X car; that is part of the problem. Alan Greenspan is suggesting that we will get past that problem as they increase their capacity. But it is true that at the moment a big surge of purchasing power into the economy is not going to resolve the automobile unemployment problem; it will take a little bit longer.

Senator **Domenici**. Do you agree with that, Dr. Greenspan?

Dr. **Greenspan**. Yes, I do.

MODERNIZED INDUSTRIES MAY REQUIRE FEWER EMPLOYEES

Senator **Domenici**. On industries like steel and the automobile industry, there is a great deal of talk that we need to change our depreciation allowance so that they will have more capital to modernize.

Does it follow that when they are modernized they will employ less people, or not, in order to be more productive—which is the goal that we are talking about, increasing productivity. Does that mean less people will be employed by the automobile and steel industry when we get those industries modernized and rebuilt?

Dr. **Greenspan**. Well, Senator, if you look at the expected growth rates of both of these mature industries, it's fairly obvious that the answer to that must be in the affirmative. The alternative is to postulate a significant acceleration in steel production growth or motor vehicle production growth in this country, neither of which sounds to me a very sensible forecast to make.

Senator **Domenici**. So that we take a risk if we jump in the middle of any of these individual financial disasters, be it Chrysler, be it First Steel Co., that needs Government help—we take a risk of building back into that industry, while we think we are modernizing, we might build back in labor arrangements and labor forces that are not really consistent with the ultimate goal of more productivity and modernization, is that correct?

Dr. **Greenspan**. Yes, sir.

Senator **Domenici**. Do you agree with that, Dr. Heller?

Dr. **Heller**. Well, I am not sure that I fully understand the question, but as I interpret it——

Senator **Domenici**. Well, let me just put it bluntly. If you go to Chrysler with a billion-and-a-half guarantee program as compared with—and I am not suggesting it, I am just giving you an example—as compared with letting Chrysler go bankrupt, and when its successor, be it a growth of one that is there or a new one, comes into being and begins to produce and compete in the world markets, my question is: Are they not apt to have less labor intensity than the company we bailed out?

Dr. **Heller**. Yes, they are; and that means they are more productive. But, you see, that was the thing that threw me a little bit about your question, because you threw in that it would not help productivity. But presumably, if you step up——

Senator **Domenici**. No.

Dr. **Heller**. That is where I was apparently misinterpreting your question. If you step up the amount of investment and if you replace less efficient with more efficient producers, of course you are going to get higher productivity.

CUT TAXES OR REDUCE EXPENDITURES FIRST

Senator **Domenici**. My last question: Dr. Greenspan, you are now aware that the predictions—and would you for purposes of my question assume they are true—that we are going to have a $30 billion deficit under the present budget policies for 1981—do you recommend that we have a tax cut that you have recommended here today for 1981 on top of that, or do you recommend that we cut the expenditures some first?

Dr. **Greenspan**. I would like to see both, Senator. The substance of my formal remarks in opening here was the fact that achieving a balanced budget, as important as that is—and I have obviously supported that at great length over the years—is for the purpose of achieving a vital and stable and growing economy.

If we allow the budget to become balanced because we allow tax receipts to rise, we may achieve our secondary goal and fail in our primary purpose. So I would direct policy for two purposes: One, to thwart the seemingly inevitable rise in the tax burden which is occurring as a consequence of inflation; and, two, focus very effectively on the question of restraining the growth in spending.

Senator DOMENICI. But precisely this year, were the economic facts as you know them—how much of the $30 billion deficit would you cut? You are saying you would do both.

Dr. GREENSPAN. I would say fiscal 1981 if we end up with a $30 billion deficit, we are doing exceptionally well.

Senator DOMENICI. Plus a tax cut?

Dr. GREENSPAN. Yes. First of all, the $30 billion, remember, includes two major initiatives by the President on the issue of taxes, which are unlikely, as I understand it, to work their way through this Congress. My recollection is that they aggregate $7 billion.

So $30 billion is not the number from which we start. And so I at this point am very much concerned about the deficits we are running. I do not believe that the fiscal 1980 number will end up as low as a deficit of $61 billion, and I would not be surprised to see a significantly higher number than, say, $38 or $39 billion, which is really where it is at the moment, for fiscal 1981.

Nonetheless, fully recognizing that, I am willing to move on the tax side because I think that merely to endeavor to await a restoration of budget balance is going to end us up probably with neither of our two goals. That's why I think the job of policy at this stage is so extraordinarily difficult.

Senator DOMENICI. Thank you.

Chairman HOLLINGS. Senator Sasser.

EFFECT OF MAJOR INCREASES IN CAPITAL SPENDING ON RECESSION

Senator SASSER. Thank you, Mr. Chairman. In answer to one of Senator Chiles' questions regarding the steel industry, Dr. Greenspan, you made the point that times change. In your prepared statement you say, "Our primary goal is a vital and growing economic system. The issues of inflation and budget balance are secondary."

Well, when I read that I realized that times do change—that certainly had a New Deal ring to it, and sounded like it might be some internal memo written by Rexford Tugwell back in 1934.

But times do change, Dr. Greenspan.

We are in the midst of a recession. I believe, in fact most of my constituents believe, that the primary cause for the severity of this recession has been some policies of the Federal Government. My question to you has to do with what is now needed to bring an end to it.

Now, after our last recession, there was no major increase in capital spending—at least that has been my observation.

Could you shed some light on why we never got this big boost in business investment, if that is accurate, and whether we can anticipate a continuing absence of capital spending as we go into recovery from this recession?

FEDERAL SPENDING INCREASED BY INFLATION

Dr. **GREENSPAN**. Senator, there was a pickup in capital spending, but you are quite correct in pointing out that it was a less-than-expected or less-than-normal rise.

I believe that there is one major cause of that, and it is inflation itself. The reason I say that is that not only did capital investment's recovery out of the last recession appear subnormal; it also exhibited an extraordinary pattern, namely, an undue emphasis on short-lived capital assets, the types of assets for which there is quick cash payoff as distinct from assets which were invested over the very longer term.

That is precisely what one would expect to see if what economists call the hurdle rates of return on the investment process rise, meaning that as business requires, because of inflation and the risks associated with it, an ever higher rate of return before it will also authorize investment. That in effect is skewing the whole structure of investment toward short-lived assets, which are, by that type of analysis, the most profitable. We saw a significant swing away from long-time payoff basic research toward shorter developmental type projects, and the whole structure of the capital markets moved toward short-lived assets, everything imploding into a quick cash payoff type of system.

And that fundamentally is what one would expect in an inflationary environment.

Now, something else is beginning to happen as well, and that is the increasing tax burdens, which didn't exist as a major issue in 1975, but are now becoming a basic problem.

What we must focus on to reinvigorate capital investment in this next cycle is a major effort to restrain inflationary forces and simultaneously reduce the tax burden, which is why I conclude we must double our efforts on the expenditure side of the budget, because the only way to bring down aggregative borrowing requirements of the Federal system and cut taxes is to bring the rate of expenditure growth down.

CONGRESS MORE SYMPATHETIC TO NEEDS OF INDUSTRY FOR CAPITAL FORMATION

Dr. **HELLER**. Senator, I agree in part with what Alan Greenspan has just said. I would add a couple of things to it.

It's true that high inflation discourages long-term investment; quick payoffs, the premium on those rises, no question about it.

At the same time, our overall proportion of capital investment to gross national product came pretty well right back to its norms of around 10 percent during the advanced stages of the recovery.

What happened was—structurally, yes, too much of it went into trucks and into almost everything on wheels more or less, short run. But the overall ratios were not very different from the midsixties when we thought investment was pretty satisfactory.

The second thing I would say is that because of the tremendous influx of labor into the labor force that we were talking about a little earlier, we were substituting labor for capital at a great rate. I think that is going to reverse in the eighties just in the nature of things; we are going to have less labor coming on the market, we are going to have more laborsaving, more incentive for laborsaving devices. Coupled with that, there is clearly—in this room and throughout Washington—a far more sympathetic view of the needs of industry for capital formation. And I think that is going to be reflected in tax laws and so forth.

So under those circumstances, particularly if we see to it that the recovery doesn't lag too much—because the fundamental force for investment is, after all, the level of markets out there. That is vastly more important than tax benefits. If a manufacturer can't see high and relatively sustained markets, the incentive for investment just drops like a plummet. That is what happened in Europe. We tend to look to Europe and say, gosh, look at the fine performance they had on inflation the past few years. Well, of course, we served as the locomotive for them; we had a strong recovery, they had a weak recovery.

Investment in Germany and some of the other western European countries was about a third per year in the 1973–78 period of what it had been in the 1969–73 period. That was the price they paid for retarding their recovery. And, indeed, our industrial output over those years increased percentagewise more than any European country.

So sometimes we do do a little bit too much handwringing and poormouthing about this American economy. We didn't just fold our tents. Industrial production here rose more than any of those countries.

Senator **Sasser**. During what period are you talking about?

Dr. **Heller**. I'll give it to you precisely. Take 1973–79—this is now industrial production: Industrial production rose 12 percent in France, 9 percent in Germany, 14 percent in Japan, 3 percent in the United Kingdom, and 17 percent in the United States. When we talk about these things, we ought to stick fairly close to the facts, and one of the facts is that we didn't do all that badly in that period.

So that was France, Germany, Japan, United Kingdom, United States—12, 9, 14, 3, and 17 percent.

I don't mean to say we haven't got a problem, but the point of departure is not one of a collapse of American industrial production.

U.S. PER CAPITA PRODUCTIVITY LAGGING

Senator **Sasser**. Well, now, those are interesting figures but we have been hearing some bad news lately. We have been hearing testimony that the rate of increase of productivity in the United States had not kept pace with that of trading partners or, rather, trading adversaries in Western Europe or Japan. And that was the underlying cause of at least a portion of our inflation, and the underlying cause of at least a portion of our economic distress. We just have not been keeping pace in increasing our productivity.

Dr. **Heller**. Well, that is not necessarily in conflict with these numbers. These numbers are overall industrial production.

You are quite right, we sort of brought up the rear on increases in productivity per labor hour in this period; yet for all that—I believe the numbers are right—we still have the highest productivity per labor hour in the world. But it's true, the others are gaining on us; every time we look behind us they are closer.

But we have had an inherent tendency in recent years in this country to poormouth our economy—and I don't want to be a Pollyanna, I don't want to avoid facing the problems we have got—but we have got enormous strengths to draw on in dealing with those problems, and we shouldn't underestimate them.

TARGET TAX INCENTIVES TO FAILING INDUSTRIES

Senator **Sasser**. Well, that's encouraging; I am delighted to hear that.

Recently we have gone through the trauma here in Congress in voting on the Chrysler bill. Many of us voted in favor of giving Chrysler some relief with great trepidation—and I was one of them. I thought Dr. Greenspan made a salient point when he discussed the experience of the United Kingdom in subsidizing inefficient or nonproductive industries which had not been good policy. And I have read that the Japanese follow just the opposite approach, that they tend to subsidize those industries that appear to be the go-go industries, on the move, coming on in the future to boost the overall economic picture.

Now, what I think we ought to try to do is anticipate the Chryslers of the future. And here we get to the question of tax incentives to encourage capital investment. Should we try to take a targeted, sectoral approach to some particular industries that might be the Chryslers of the future, and, if so, what do you anticipate these industries might be in the next 5 years?

REVIEW AREAS WHERE FEDERAL POLICY INHIBITED INDUSTRIAL GROWTH

Dr. **Greenspan**. Senator, my first priority would be to first attempt to review the areas where Federal policy has in fact been detrimental to the advance and the growth of American industry. I know of no subsidy nor of any particular tax break which would have created the extraordinary communications industries of the United States. It was American initiative, insight, technological know-how, and an extraordinary industrial base which enabled us to achieve what we have achieved. And it's very impressive.

What the Japanese do, as I understand it, is they foster the market, they don't basically create new industries merely through Japanese central government policy. What they tend to do is try to reinforce the strong underlying propensities to advance and to create new things, and they have done it well.

I regret that in too many instances Federal policy in the United States has been, if not explicitly focused in an antibusiness way, its effect has become that. And the Japanese think in precisely the opposite way.

So my inclination would be to go in a somewhat different direction, not to think in terms of how do we subsidize our better endeavors, but, rather, how do we leave them alone so they can flourish.

Senator **Sasser**. Well, we left Chrysler alone, Dr. Greenspan.

FEDERAL REGULATIONS CREATED FALSE SIGNALS FOR AUTO INDUSTRY

Dr. **Greenspan**. No, I am afraid we did not. We created many problems for Chrysler, which, coupled with the vast number of mistakes which they seemed to create themselves, put them in a dreadful mess.

I am sure that our endeavors toward simultaneously working to, one, maintain a major thrust on the environmental side—but, more importantly, by restraining the market price of oil, as we have, we created false signals for them. We may very often talk about how delightful the adjustment process has been in Europe to higher oil prices, and how they have managed—and they have done well. We cannot easily castigate the American automobile industry by saying why didn't you come up sooner with the smaller car, when in fact because we suppressed the price of oil their customers didn't want the smaller car. They wanted the larger car. There were some very great difficulties in 1976, 1975, and 1977. Had we allowed oil prices to move to where they in fact are today, I would suspect that the American public would have moved far more quickly toward embracing the smaller car, that many of the mistakes in moving toward larger car assembly by domestic U.S. manufacturers in recent years would not have occurred—and, while I am scarcely about to say that Chrysler would not be in a very difficult state at this point, I would suspect that they would be in far better shape and surely Ford and GM would be in better shape.

So before we move on to a reindustrialization policy which strikes me as trying to shore up American industry, we should first look where we can remove the inhibitions to productivity, growth, innovation, and the like, which we have, in my judgment, too readily moved toward, I think we have not been appropriately conscious of the impact which these regulations have had.

Chairman **Hollings**. Jim, can you yield?

Senator **Sasser**. Yes, Mr. Chairman.

Chairman **Hollings**. To Howard—he has been here four times and hasn't been able to ask a question, and I am afraid these gentlemen are going to have to leave.

AUTO INDUSTRY SWAYED BY BIG CAR PROFITS

Senator **Metzenbaum**. I would just say as a prefatory comment, Dr. Greenspan, that I have heard a lot of different things stated over a period of many years about the oil situation, but yours is the first apologia as to why the auto industry blew it, and it was all the fault of holding down oil prices.

Dr. **Greenspan**. Senator, I wasn't aware that that is exactly what I said.

Senator **Metzenbaum**. Well, it sort of sounded like that to me, at least—I guess it isn't so much what we say as what the perception is of what we say. And it seemed to me that you were making that kind of an explanation. Everybody in the whole nation was saying we want cars that get more gas mileage. The Senate passed legislation to that effect. The oil companies helped to kill it in the House. I think they just thought they could make more money by selling the big cars.

Dr. **Greenspan**. Well, Senator, in fact it happens to be true they could, but that is largely because the demand was for big cars. They can't make money today on big cars, as you well know, Senator; you couldn't unload some of them. And had we had the changing market characteristics several years ago, I would venture to say that we would have fended off that last undesirable surge of the big gas guzzlers sooner.

Now, I grant that I am speculating on events after the fact, and that is very easy to do, but I must say that is my impression, looking at the data.

Senator **Metzenbaum**. I heard so often several years ago about the American preference for big cars—they wanted the gas guzzlers, they were willing to pay more for it. They just misjudged the market, they misjudged their own situation. But I don't really think that is necessarily the main thrust of your testimony—and that does concern me.

As I get your testimony, you are really saying: You can balance the budget, you can cut taxes, you can increase defense spending, and you can do a lot of other things, and then you are going to solve the problem by the following:

> We must focus on achieving budget balance, but in the context of lower tax rates. This requires a double-pronged effort to keep the trend of expenditures down while gradually removing inflation collections from our tax system. This can be achieved, first, by simulating indexing through a series of programmed tax cuts, and, later, by locking in an indexing system to avoid a resurgence of the inflation tax problem over the longer run.

Now, I have been trying to figure out how you and Mr. Reagan and some others are going to do all these things, and you have explained it in a paragraph I can't understand. If you could explain the paragraph for me, maybe I could go out of here elucidated, really well-informed.

UTILIZE FLEXIBILITY OF BUDGET PROCESS

Dr. **Greenspan**. I will endeavor to do that, Senator, as best I can.

We start to project, first, where current law takes us—what the CBO and others are doing now. In addition we add the normal increments of inflation, which are not mandated by law, such as the automatic increase in the compensation of Federal employees, the defense procurement cost escalations, and the like. That gives us a very substantial surplus in—as of early January, as I recall, close to $180 billion for fiscal 1985.

What causes that to occur is that a current services budget by its very nature does not increase the real Federal outlays. And if you then start from that base, and you ask yourself, one, what type of defense outlays can you add to that. I have been in the process of trying to price out a number of different programs, starting with a not inconsequential budget authority already in place as reflected in President Carter's budget. There are, you quickly find out, some major—physical—restraints to how far you can go. There is a limitation, for example, on the number of F-18's we can turn out. We have certain problems with respect to aluminum plate capacity and obviously we can move in the direction of the MX only so quickly. I am not at liberty at the moment to put out figures—which is another way of saying I am not sure my numbers are right yet—but I have convinced myself that we are at this stage in an area where, with the Roth-Kemp bill, some variation of a major accelerated depreciation bill, a significant acceleration in defense expenditures, over and above where President Carter is, still leaves us with remarkably considerable flexibility in the budget process, provided that we do not create significant add-ons to existing programs. I am not even talking about major curtailments in programs.

Senator **Metzenbaum**. Where does it come from?

GROSS TAX CUT

Dr. **Greenspan**. Well, it starts off, there are two major areas—let me take, for example, what I presume Secretary Miller was probably testifying on this morning, since I have heard him before. He comes up with a gross tax cut advocated by Governor Reagan, as I recall, of $282 billion in 1985. The number is actually less than that, but it's a substantial number unquestionably.

If you introduce defense outlays on top of that, and you then endeavor to determine what happens if you start off with a very large current services budget, and you have some reflows, not the reflows which somehow magically create more revenues than you lose. This is not a breeder reactor operation, it is really quite remarkable how close you get to a balanced budget and in certain scenarios a surplus in fiscal 1985.

Now, that is not what I am forecasting is actually going to happen, but I do argue that the assumption that somehow everybody is playing games with numbers is just not accurate.

Senator **Metzenbaum**. I must confess, I still don't follow where it comes, but I want to ask you one more question, and then I must go vote.

Chairman **Hollings**. Let me interrupt at this particular point, if you don't mind. Senator Exon, we want to thank you very much—he has already voted, you continue with your question, and then Jim has a few questions. And we appreciate your sticking this long with us, and you are a wonderful help to us, too.

Thank you.

SUPER MAJORITY VOTE FOR MONEY BILLS

Senator **Metzenbaum**. One last question. You have indicated a most unusual proposal for a constitutional amendment that is very undemocratic: 60 percent majority to cut down spending, let's go to 70 percent, let's go to 80 percent, let's go to 90 percent. If 60 percent doesn't work, we can keep going up.

That is not the way our Government really functions.

My real question, though, is not on that. My question is—you are a Reagan economic adviser (I gather very close on this subject)—does your point with respect to the 60-percent majority in order to pass appropriations bills and authorization bills, are you speaking for Governor Reagan in that connection?

Dr. **Greenspan**. No, Senator, I am speaking for myself. This is an amendment that I have been recommending for the last several years before the Judiciary Committees of both the House and the Senate.

If I may just take 1 second——

Senator **Metzenbaum**. If I miss my rollcall, you are going to have to explain how I voted.

Dr. **Greenspan**. I will explain it some other time, Senator.

Senator **Metzenbaum**. All right, please forgive me; I don't mean to be rude.

AREAS OF DISAGREEMENT WITH MID-YEAR ECONOMIC OUTLOOKS

Senator **Exon**. Gentlemen, I wish to apologize for the in and out today, and we consider you both very important witnesses. I am going to try and close up here, but I have a few things I would like to ask you.

The Chairman before he left asked me to raise one question to both of you. Do you agree basically with the CBO estimates that have just come out that we are working on, and if you do not agree with them, could you detail for us where you might disagree?

Dr. **Heller**. CBO or the administration?

Senator **Exon**. CBO.

Dr. **Greenspan**. I don't know that we have had——

Dr. **Heller**. I think they are coming out tomorrow.

Senator **Exon**. Let me phrase it this way: Administration and/or CBO.

HIGHER UNEMPLOYMENT AND DEEPER RECESSION THAN PROJECTED

Dr. **Heller**. Well, in my testimony I tried to indicate by interpolation where I disagreed with the administration forecast. I understand from some advance leaks that the CBO forecast also foresees somewhat less of a recession this year and somewhat less of a recovery next year than my combination of numbers and intuition would lead me to expect. I come back to the point that this slide, while we see some very reassuring signs that the bottom is not going to drop out, that there are some self-limiting factors, that it is not leading to panic and imbalance and so forth, as for a while the 1974-1975 recession did—but these things are very hard to turn around real fast, and that's why I look for roughly a 4-percent drop, while the administration and CBO, I understand, are talking about less of a drop. Therefore, I also would project a higher rate of unemployment peak than they do.

FASTER ECONOMIC RECOVERY

As to next year, they seem singularly pessimistic. Granted, that is not plugging in a tax increase, but a 2.6 percent growth rate next year, as the Administration forecasts, is a dismal performance by comparison with the whole postwar record. There wasn't a single postwar recovery in the first four quarters after the trough less than 4.6 percent, and the average, as I have pointed out in my testimony, was close to 7 percent in real terms.

Now, recessions differ, business cycles differ, recoveries differ; we are more chastened about inflation, we are not going to, as I said earlier, open the spigots. But I still think it's very hard, once recovery gets going, to hold it down as low as the administration seems to indicate.

So I would expect somewhat, not dramatically more, but somewhat more expansion, somewhat more improvement in 1981 than the administration.

Senator EXON. Thank you, Dr. Heller. Dr. Greenspan?

BOTTOM OF ECONOMIC DOWNTURN BY END OF YEAR

Dr. GREENSPAN. I have had no chance to closely look at the forecasts in detail, but where the differences lie between CBO and the administration and private forecasters is not sufficiently significant to, in my judgment, raise an issue, on the grounds that our range of error in these forecasts is really quite substantial. They are all in effect saying that the bottom is close to the end of the year or thereabouts, that the recovery will not be characterized as robust. And once one says that, our state of the art, so to speak, is being pressed way beyond its capacity to answer. And I would be very hesitant to make anything special about minor variations which, at least as best I can judge, exist between CBO, OMB, CEA, and most of the private forecasters with whom I am associated.

GNP REAL GROWTH

Dr. HELLER. May I just add, I see that the comparison of the economic forecasts suggests real GNP growth in 1981, under the CBO, of 3.5 percent, fourth to fourth. That is just about on the nose of what I would forecast, and so my premonitory view of the CBO forecast must have been wrong—3.5 percent looks very close. The administration, 2.6 percent, that looks a little thin.

I agree entirely with what Alan says, and yet when somebody puts a gun to our head and says, you know, what do you think the forecast is going to be, you have to come up with your best judgment, and my best judgment is significantly above the administration's 2.6 percent and maybe a shade above the CBO and consensus of 40 private forecasters of 3.5 percent for next year.

CONTROLLING FEDERAL EXPENDITURES

Senator EXON. You have both been around long enough to know that one of our most difficult jobs here, of course, is to try to control expenditures and get them into line. But, you know, we can work for days and days and days—we've got a billion here and a billion there—you know, we have argued around this table for something sometime around $50 million for 2 or 3 days. Then we find, when we start finetuning this, we get down to the situation where we are way out of line.

A year ago we were sitting around this table predicting a balanced budget for 1981 and a $55 billion surplus for 1982. The only discussion at that time was how we were going to employ that $55 billion surplus in a tax cut—that was the discussion. Now we find out that not only we are not going to have a $55 billion surplus, but we are talking of a $30 billion deficit. So those total up to somewhere around a $80 billion change in a relatively short period of time, 12 months.

So when we keep grilling you on these things—I think what we are seeking here is expert advice from people like yourselves, to try and help us do the job that we must do.

ENTITLEMENT PROGRAMS

And I notice in some of your testimony and some of the testimony that we received from witnesses this morning, there seems to be some feeling among some of the economists that maybe we don't get down and do the hard job that we should do on some of these areas. But certainly we all have to recognize that there are so many variables, which brings us into the discussion of the entitlement programs. We have been discussing entitlement programs such as food stamps, for example. Each and every year we come up with a deficit on food

Now, you can argue, well, we just didn't appropriate enough money for food stamps in the original instance. I think and suspect that the only way we are ever going to be able to get a handle on the food stamp program is to have a wrenching mechanism of some kind where, if during one quarter, the Secretary of Agriculture finds that he has expended more than one-fourth of the total food stamp authorization, he may have to cut back 10 or 15 percent for the next quarter. That kind of a wrenching effect, of course, would have an effect on those on the lower end of our economic scale who generally benefit from the welfare programs, the social programs.

How do you feel about possibly putting into effect some type of a pro rata system once the Congress has said this is the amount of money we are going to spend for certain programs? Aside from the political aspects of that, how does that idea strike you as economists, is it workable?

Dr. **Heller**. It seems to me the chances are that you would be cutting back on some of those programs just when they were needed most. The reason that the food stamp program would exceed that quarterly allotment would be either recession or inflation, or both, which puts the recipients of those programs in a terrible bind. And to have an automatic cutback under those circumstances could be awfully tough. This isn't an answer as an economist; this is an answer as a human being. But I really find that a very difficult kind of dilemma.

PERCENTAGE OF CLAIMANTS TO PERCENTAGE OF THOSE QUALIFIED RISING

I might say—and I'm sure that a lot of the people in this room are a lot closer to this than I—but some studies indicate that welfare programs were more expensive than projected because many of the qualified beneficiaries had not yet claimed their benefits, and that in the sixties and seventies as they came forward, costs balloned. But now in the eighties we will get the benefit of the fact that that upward movement of the ratio of actual claimants to the number who are qualified, will get close enough to a 100 percent to result in some tapering off of some of those pressures under the entitlement programs.

Senator **Exon**. The opposite has been happening, but you think that it may taper off, so that when we appropriate the amount of money for food stamps, for example, in a relatively stable economy, that it should hold?

Dr. **Heller**. As far as this factor is concerned, that is, percentage of qualified applicants that has claimed its benefits. The study I saw was pretty persuasive to me, and I thought it gave us a little hope for some tapering there over the longer pull.

But you are not going to overcome the growth of those programs short-run when recession strikes and when inflation strikes.

Senator EXON. Any comment, Dr. Greenspan?

ENTITLEMENT PROGRAMS ENCUMBERED BY POOR ESTIMATING PROCEDURES

Dr. GREENSPAN. The individual programs are a problem only in the sense that our estimating procedures on what the entitlement actualities will be tend to have been on average estimated too low. There is no way to cure that; that is just basically poor estimating procedure. And when I was involved in the Council of Economic Advisers, we made very strong endeavors to try to alter that. I am not sure you can.

But rather than endeavor to restrict individual programs per se, I think the focus should largely be on avoiding the inadvertent creation of new ones which occur——

Senator EXON. Or the expansion of existing ones.

Dr. GREENSPAN. Or the expansion of existing ones. I know of no way, once an entitlement is in place, to then proceed to alter it. When the Congress creates an entitlement, the only thing that is missing is a forecast of what that will generate in terms of cash outlays. It strikes me as somewhat unjust to penalize the recipients under the entitlement programs for our ability not to be able to estimate the numbers correctly.

Senator EXON. Estimates are historically low rather than high.

Dr. GREENSPAN. That is correct. There are lots of reasons for that which I am sure, Senator, you can name far more quickly than I.

Senator EXON. Give me another year or two, and I think I could name them.

Dr. GREENSPAN. I have a suspicion you already know most of what you need to know.

REESTABLISH FISCAL RESTRAINT BY CONSTITUTIONAL AMENDMENT

Senator EXON. I would like to follow up with your constitutional amendment. I was not for a constitutional amendment when I came here, but I am convinced that we are going to have to do something like that to get the discipline that we need up here, as undemocratic as it might be, as my friend from Ohio pointed out before he left.

On the constitutional amendment, do you feel that that should be done through the standard process of ratification by passage in the Congress and ratified by the States, or would you favor a constitutional convention?

Dr. GREENSPAN. I am very fearful of a constitutional convention, Senator. I would much prefer the normal processes, which, if it passes, is the most democratic of all mechanisms that our constitution has created.

Senator EXON. So therefore the answer to my question would be you would favor the State ratification process.

Dr. GREENSPAN. Yes, sir.

Dr. HELLER. Could I——

Senator EXON. Yes, sir.

MINORITY OF CONGRESS COULD RULE MAJORITY

Dr. **Heller**. I don't want this afternoon to pass without registering just a diametrically opposite view—we haven't had many between the two of us. But I just cannot see embedding in the constitution a provision that calls for a super majority on the guts of Government. I mean, the appropriations process is the guts of Government, and what we are saying is we want minorities to be able to rule. I agree in spades with Senator Metzenbaum's point. That means that 41 percent of the Senate and the House can kill a proposal.

Now, we have wisely limited in our congressional process the super majorities to, I recall, a handful—five things, like overriding a veto and cloture—you know, there is a very small number. And I think that is very wise. I happen to believe so strongly in majority Democratic Government—or, for that matter, majority Republican Government—that I just shy away from this process of saying that we should suspend majority rule.

Senator **Exon**. I know it's not as complicated, but it does work in State government, Dr. Heller.

Dr. **Heller**. Yes, and I am not sure I like it there either, not in the constitution.

Senator **Exon**. In the constitution in Nebraska it works quite well because if people vote to spend more money than the present taxes will bring in, then they have to raise taxes. And that works out quite well as a restraint on people spending money.

Dr. **Heller**. But that is a rather different thing. The balanced budget is a way of life, a correct way of life, for families, for business units, for State and local governments, which don't have the same responsibilities, don't have monetary powers and so forth. No, in that sense, you have to maintain budget balance at the State and local level—I think that's perfectly reasonable.

But not for the Federal Government.

OFF-BUDGET ITEMS

Senator **Exon**. You indicated in your earlier testimony, Dr. Greenspan, that you felt that some of the off-budget items were certainly one of the driving forces of inflation.

Would you care to enumerate those that you think are the biggest problem in that area? Are you speaking of the Federal housing programs, for one, that are off-budget? Could you give me an example, three or four, that come to your mind?

NEED FOR CREDIT BUDGET IN BUDGETARY PROCESS

Dr. **Greenspan**. Senator, in one of the more important analyses that we have in the budget—I believe it is in special analysis E and F—we outline the credit guarantee and other claims on credit that are instituted by Federal programs. And there is a long list of them, one of the bigger items being in housing mortgages.

And it is not an accident that outstanding mortgage debt, which used to increase about $20 billion a year, has in recent years been increasing in excess of $100 billion a year. It has rapidly become the largest segment of our financial system, dwarfing the corporate bond market, in fact even dwarfing on-budget financing of the Federal Government itself.

And that has put, as best I can see, tremendous pressure on the commercial banking system to overextend on the issues of money supply and liquidity generally. And that is the reason why, in any budgetary process, I believe that to not have a credit budget, as is now being endeavored to be instituted, is a mistake and a major loophole in our budgetary processes.

Senator EXON. I don't believe you commented on that, Dr. Heller—if you did, I was out of the room. How do you feel about that?

Dr. HELLER. Well, I am all for embracing the inclusion of the credit activities of the Federal Government in some kind of comprehensive procedure. I think that is good responsible decisionmaking and financing.

At the same time, we should very carefully distinguish, as indeed one of the budget committees, which was chaired by the former Secretary of the Treasury—was it David Kennedy?

Dr. GREENSPAN. That's correct.

Dr. HELLER. And they pointed out that we should very carefully distinguish between those guarantee and loan and credit programs that are more or less tantamount to Federal spending, and those that really involve very little Federal subsidy, that really are the counterparts of private lending activities. I don't think we should, in other words, go to the extent of assuming that every time the Federal Government lends money that it is stepping up and stimulating the economy to that extent. Very often it is simply adding a very small amount net to what otherwise would have been done in the private economy.

And the recommendation of that commission was to identify that part which is essentially Federal expenditure or Federal subsidy, and distinguish that very carefully from the part where there is simply a substitution of Federal for private credit.

And with that proviso I would go all out to bring all of those activities into the orbit of Congressional and White House control.

IMPACT OF OFF-BUDGET PROGRAMS ON GNP

Senator EXON. Since we talk about GNP all the time—it's a very important fact that we work with—do you have any ideas, either one of you, how much less the GNP would have been if we had had some kind of control on these off-budget items? Would it have been significant? It would have been less, I am sure.

Dr. HELLER. Well, if by control you mean cutting them off.

Senator EXON. All these off-budget items out there right now are almost like entitlement programs over which we have little or no control.

Dr. HELLER. If the control would mean substantial cutback of them, yes, nominal GNP would be curtailed to that extent.

Dr. GREENSPAN. I think we would have seen a very significantly less buoyant expansion in the home building industry, very substantially less in the way of price increases and capital gains financed by mortgage credit, and very much less in the way of retrenchment in housing that we have seen in the last 6 months.

Senator **Exon**. Gentlemen, I thank you very much. It's been a very interesting discussion and very helpful to us. If you have nothing further to say, the meeting would stand adjourned.

[The committee adjourned at 5:24 p.m.]

ECONOMIC BACKGROUND FOR THE SECOND CONCURRENT RESOLUTION FOR FISCAL YEAR 1981 AND CBO RE-ESTIMATES

WEDNESDAY, JULY 23, 1980

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 6202, Dirksen Senate Office Building, Hon. Ernest F. Hollings (chairman of the committee) presiding.

Present: Senators Hollings, Chiles, Sasser, Exon, Bellmon, Domenici, Kassebaum, and Pressler.

Staff present: John T. McEvoy, staff director; Susan J. Lepper, chief economist.

For the minority, Robert S. Boyd, staff director; Gail D. Shelp, senior economist.

OPENING STATEMENT OF CHAIRMAN HOLLINGS

Chairman HOLLINGS. If we can have a little order, please, we will get started.

This is the third of the Budget Committee's five hearings previous to the Budget Committee markup. Our witness today is Alice Rivlin, Director of the Congressional Budget Office.

It is sometimes the unpleasant duty of the CBO Director to bring us bad news. The committee met earlier this morning, Alice, and voted not to shoot you as the messenger; the vote was 9 to 7. [Laughter.]

We do know, however, that we have had bad news. We are dismayed by the news of a $29 billion deficit when we had strived so hard to balance the budget. We need to know why the forecast of last March was off the mark and how these revisions in spending and revenues came about. It is important for us to explore the problems with that forecast to be able to assess the risks in the current estimates.

We need your assessment of the new pessimistic economic estimates by the administration. We also want your appraisal of the policy alternatives before us. Is it still possible to balance the 1981 budget? Should taxes be cut? If taxes are cut, what should be the split between personal tax rate changes and investment-oriented tax reductions? How big a tax cut or spending increase would be required to cut unemployment in 1981 by 1 percent? 2 percent? What would be the deficit and inflationary effects of such a Federal policy?

Specifically, I think your figures are agreed upon by all the witnesses thus far. We were asking each of the witnesses as they came before us, and the last two—Dr. Heller and Dr. Greenspan—whether they had any substantial differences between their projections and what your CBO economic projections were, and they had no substantial differences. So they agree with you. That helps us, because you begin to wonder sometimes if I were a President and I were running for reelection and I had to predict going up to 8.5 to 9 percent by the end of the year, with an average of 8.5 or 8 percent for all of next year, then politically there might be some suspicion that maybe the more nearly accurate figure would be 9 or 10 percent, but since it is an election year, I will hold it down to 8.5 percent. But it makes me feel better to have Governor Reagan's economists come and say that your figures are accurate and former President Kennedy's economists come and say you are accurate. So we have got to have confidence in you.

Let me yield to Senator Bellmon and then Senator Sasser, and then we will start.

OPENING STATEMENT OF SENATOR BELLMON

Senator **BELLMON**. Mr. Chairman, I have a prepared statement that I would like to have included in the record. But I have only one point I would like to really raise with Dr. Rivlin, and perhaps the time is when we get to questions.

PROJECTED HIGH UNEMPLOYMENT QUESTIONED

I am not going to quarrel with our chairman's agreement that your figures are accurate. These are guesses we are dealing with, or assumptions. What I cannot understand is what has happened in these last 5 weeks that has caused the assumption of 7.5 percent unemployment to go up to 9 percent. As I read the records, both housing starts and car sales are up. Those are the two elements of the economy that have been most adversely affected. I hope Dr. Rivlin will give us, during her testimony some reason to understand why the prospect is so much more dismal now than it was 5 weeks ago, when I can look at what is happening and take a little hope that things are going to get better and not that much worse.

PREPARED STATEMENT OF SENATOR BELLMON

Mr. Chairman, It is always a pleasure to have Dr. Rivlin testify before this committee. The Congressional Budget Office is our official budget estimator and policy analyst. I hope that we can look to the CBO for guidance in this political year, when campaign politics can take a front seat to common sense. I have had the opportunity to review Dr. Rivlin's economic forecast and the revised spending estimates for fiscal year 1980 and 1981 and I would like to express two concerns before we get on with the hearing. First, I think that the duration of the recession is likely to be shorter than CBO projects and, second, I think that the rise in the unemployment rate will be less.

RECESSION LIKELY TO BE SHORTER THAN CBO PROJECTS

The CBO forecast shows the economy continuing to decline, somewhat sharply in the current quarter, a small decline in the fourth quarter and a recovery only at the beginning of 1981. Although I am certainly not an economist, myself, the prediction of such a long period of economic decline is simply not consistent with what I observe in my own state of Oklahoma and what the economic statistics tell me about the economy of the nation.

I note particularly the encouraging economic news of recent days that suggests that recovery in some of these economic sectors that have been most depressed is already underway. Early July automobile sales increased to 7.0 million units from 5.2-5.3 million units in May and June. Interest rates have dropped substantially and housing starts have tuned up by over 30 percent in June.

CBO FORECAST FOR UNEMPLOYMENT RATE QUESTIONABLE

I am also puzzled by the CBO forecast for the unemployment rate. I realize that the unemployment rate has shot up since March and a look at the decline in industrial production during the past three months provides a clear explanation why. However, because I believe that economic growth will be stronger than the CBO economic forecast presently shows, I also believe that the unemployment rate will be significantly lower than the 9.0 percent that CBO projects. I realize that I may be considered optimistic by some, but I understand that economists such as Henry Kaufmann would be included to agree with me. The CBO economic forecast is extremely important to the basic spending estimates in the Budget, I hope that Dr. Rivlin will describe for us in some detail why she takes such a dismal view of the economy.

CONTINUE POLICY OF FISCAL RESTRAINT

I am also concerned that the rapid shift in economic expectations which are reflected in the most recent CBO forecast opens the door of economic policy mischief. Congress made a commitment last year to fiscal restraint and a balanced budget in fiscal year 1981. This commitment was not made with any artificial expectation that a balanced budget would solve our economic problems. Rather, it was hoped that a balanced budget and restrained Federal spending over several years would help ring out the strong inflationary bias in the economy.

Just the same, I believe that the nation benefits from a serious effort to rationalize program needs within the resources that we have at our disposal. A fiscal policy that succeeds in imposing some constraint and consistency on Congressional actions would contribute more to economic and financial stability and to reducing the underlying rate of inflation, than any set of tax or spending measures that I can think of.

I hope that Dr. Rivlin will also analyze for us this morning the many policy options, particularly tax reductions that are being proposed. I also hope that she will discuss the possible effects of these policies on interest rates and financial markets, should the economy prove stronger. I look forward to her testimony this morning and welcome her to our Committee.

Chairman HOLLINGS. There is a difference of opinion between Senator Bellmon and myself. He is definitely optimistic. I want to be. In fact, I am tired of Ray Brady. Even with a bull market, he reports the stock market is just miserable.

But, in any event, as Senator Bellmon was pointing out, you have the increase in housing starts. They could come on with a small automobile. It should not be all necessarily doom and gloom. I do not see how that 8.5 percent unemployment is going to persist all during 1981, or why it should.

Senator Sasser.

Senator SASSER. I have no statement, Mr. Chairman. Thank you.

Chairman HOLLINGS. Thank you.

Pete.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, I share Senator Bellmon's concern. I really can hardly believe that the economic forecasts are true. I do not know how they changed so fast, and I am interested in your analysis as to why. It does seem to me that the average for the entire year on unemployment is extremely high. It indicates that we are not nearly bottomed out, or else it could not possibly be what you are predicting.

Aside from that, I would just say that having heard from five people yesterday, I understand the difficulty you have in trying to get consensus from economists. I mean, they were all over the waterfront yesterday not only on estimates, but also on what we ought to do.

Thank you, Mr. Chairman.

Chairman **Hollings**. Thank you.

Dr. Rivlin.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. **Rivlin**. Thank you, Mr. Chairman. These are good and puzzling questions, and I will try to address some of them in my statement. I am reassured that the committee is not going to shoot the messenger. I am mildly reassured that Walter Heller and Alan Greenspan see the economy approximately the way we do. But I think Senators Bellmon and Domenici are quite right—one should not be too reassured; just because economists agree does not mean they are right. We have all been wrong before.

Senator **Bellmon**. Does it not give you some cause for concern when Heller and Greenspan agree? [Laughter.]

Dr. **Rivlin**. Yes, it does.

I am pleased to appear before this committee as you prepare for the difficult task of marking up the second concurrent resolution on the budget for fiscal year 1981. The economy has changed significantly since last March when the Congressional Budget Office prepared the forecast on which the first resolution was based. Unemployment is higher than expected, while inflation continues at a very rapid rate and productivity lags. Partly because of the altered economic conditions, the budget deficit is expected, to be larger in fiscal year 1980, and a deficit of about $30 billion is now projected for fiscal year 1981, without any new actions by the Congress.

In making decisions on the second resolution, the committee must again ask itself the tough question: What is appropriate fiscal policy when both unemployment and inflation are high and productivity growth is slow?

RECENT ECONOMIC DEVELOPMENTS

The economy is in its seventh recession since World War II. The drop in economic activity has been exceptionally rapid. Constant-dollar gross national product fell at a 9.1 percent annual rate in the second quarter, equaling the sharpest single-quarter contraction of the postwar period. Even with no further deterioration, the 1980 downturn would be about in line with the average peak-to-trough drop in real output during the six previous recessions in the postwar period.

The speed of the recent contraction is also evident in the labor market data. Between February and June, unemployment jumped by 1.7 million workers; total jobs fell by 1.4 million; and the average factory workweek dropped by an hour.

To date, the downturn has been concentrated in consumer durable goods, especially automobiles, and in housing. The sharp drop in household spending reflects two major developments. First, disposable incomes have been squeezed by rapid inflation, slow employment growth, rising tax burdens, and higher debt repayments. Second, interest rates shot up to record levels in March and April, and credit conditions became very tight, as the Federal Reserve sought to contain accelerating inflation.

Even though it is difficult to spot developing trends during a period of rapid change, there are indications that the downswing in household spending may be bottoming out: retail sales rebounded in June, in part because automobile sales increased; housing sales and starts, as well as building permits, were up substantially in June; and consumer attitudes about the future have improved somewhat according to recent surveys. The key to these events is the swift decline in interest rates from their record levels in the spring. Other developments were the dismantling of credit controls and the deceleration in the rate of consumer price inflation.

Unfortunately, these signs of increased household spending do not mean that the recession is over. Overall economic activity is likely to slow further, though at a more moderate decline in the second quarter. Business inventories are expected to be worked down to a level more in line with lowered sales expectations, and the recession is likely to spread to other sectors, such as business spending for plant and equipment.

THE CBO FORECAST

Assuming a continuation of the spending and tax policies of the first concurrent resolution, the CBO projects that the recession will end this year and will be followed by a relatively weak recovery in 1981. The forecast is detailed in table 1.

TABLE 1.—ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1980 AND 1981, BASED ON POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1981

Economic variable	Levels			Rate of change		
	1979:4 (actual)	1980:4	1981:4	1978:4–1979:4 (actual)	1979:4–1980:4	1980:4–1981:4
GNP (billions of current dollars)	$2,457	$2,547–$2,648	$2,811–$3,036	$9.9	$3.7–$7.8	$10.4–$14.6
Real GNP (billions of 1972 dollars)	1,440	1,378–1,407	1,413–1,471	1.0	−4.3– −2.3	2.5–4.5
General Price Index (GNP deflator, 1972=100)	171	185–188	199–206	8.9	8.3–10.3	7.7–9.7
Consumer Price Index (1967=100)	228	252–257	273–283	12.7	10.5–12.5	8.3–10.3
Unemployment rate (percent)	5.9	8.4–9.4	8.4–9.4			

Source: Congressional Budget Office.

Real gross national product is forecast to decrease between 2.3 and 4.3 percent during 1980; about two-thirds of the projected decline has already occurred. During 1981, real GNP is expected to rise between 2.5 and 4.5 percent. The unemployment rate is projected to continue to rise this year, reaching 8.4 to 9.4 percent by the fourth quarter, and continuing in this range through 1981. The GNP deflator is forecast to rise by 8.3 to 10.3 percent during 1980, decelerating to a 7.7 to 9.7 percent range in 1981.

Despite the high level of unemployment projected for 1981, inflation is not expected to slow by very much in the next year. Rising wages and other business costs, decontrol of domestic oil prices, higher social security taxes, and an increased minimum wage are all expected to contribute to the continued momentum of inflation in 1981.

Important uncertainties cloud the economic outlook. Consumers could resume spending rapidly during the second half of 1980, perhaps causing an upturn in overall activity before the end of the year. On the other hand, consumers could hold back more than anticipated, rebuilding their savings and delaying the recovery until later in 1981. Other factors that would change the forecast include a substantial drop in the exchange value of the dollar, a disruption of imported oil supplies, a major crop failure, or a rapid slide into recession by some of our international trading partners.

THE BUDGET OUTLOOK

The sharp deterioration of the economy has changed the budget outlook considerably since the first resolution for 1981. The unexpectedly sharp drop in output and the higher than anticipated rise in unemployment reduce expected Federal revenues and increase outlays. We now estimate that the budget deficit for fiscal year 1980 will be over $60 billion, or about $16 billion above the level set in the revised second budget resolution for 1980. This change includes a reduction in estimated revenues of about $9 billion and an increase in estimated outlays of over $7 billion. This is detailed in table 2. The recession accounts for about $4.5 billion of the increase in outlay estimates and for almost all of the lower revenues expected in 1980.

TABLE 2.—ACTUAL AND PROJECTED FEDERAL BUDGET TOTALS, FISCAL YEARS 1979–81

[Dollars in billions]

	1979	1980		1981	
	Actual	Revised second resolution	CBO estimate based on actions to date	First concurrent resolution	CBO estimate with policies of first resolution
Receipts	$465.9	$525.7	$517	$613.8	$600–605
Percent change	15.9	12.8	11.0	16.7	16.5
Outlays	$493.7	$572.7	$580	$613.6	$630–635
Percent change	9.5	16.0	17.5	7.2	9.1
Deficit (—) or surplus	–$27.7	–$47.0	–$63	$.2	–$25– –35

The economic downturn this year and the projected modest recovery next year also make it extremely unlikely that the 1981 budget can be balanced as planned under the first budget resolution. Based on our latest economic forecast and a continuation of the tax and spending policies of the first resolution, CBO estimates that the 1981 budget will have a $25 to $35 billion deficit. Lower than expected incomes resulting from the more severe recession will reduce revenues by an estimated $9 to $14 billion below the first resolution target.

CBO estimates that 1981 outlays will be up $16 to $21 billion from the first resolution target. Outlays for unemployment insurance, trade adjustment assistance, and public assistance programs are estimated to be between $8 and $10 billion higher than assumed in the first resolution. Higher spending rates for defense and other programs are estimated to add another $13 to $16 billion to 1981 outlays. These outlay increases will be offset somewhat by lower interest costs—perhaps about $5 billion less than previously estimated.

CURRENT FISCAL POLICY

Under current budgetary policies, Federal fiscal policy would shift dramatically from expansive in 1980 to restrictive in 1981. The growth in total outlays would slow considerably in 1981 under the first resolution spending policies. As shown in table 2, total Federal spending is estimated to rise by 9.1 percent in 1981, as compared with a growth of 17.5 percent in 1980, a considerably slowing. The deceleration in outlay growth in 1981 is reflected in all major categories of spending except defense.

In contrast, and despite the projected weak economy, we estimate that Federal revenues under the first resolution policies will grow at about 16.5 percent in the next year, as compared with an estimated growth rate of 11 percent in 1980. A large part of the growth in revenues in 1981 results from the scheduled increases in social security taxes, the windfall profits tax on oil, and the rise in effective personal income tax rates because of bracket creep. These three factors alone account for about $37 billion, or roughly half, of the $80 billion projected increase in current law revenues for 1981.

The effect of the accelerating revenue growth and the decelerating expenditure growth will be to reduce the size of the budget deficit from over $60 billion in 1980 to about $30 billion in 1981. Reducing the Federal deficit in a period of high unemployment tends to restrain economic activity.

The restrictiveness of the 1981 budget under the policies embodied in the first resolution is most evident when we translate these policies to an economy functioning at the full-employment level, or at some constant level of unemployment. The shift toward restraint in fiscal 1981 can then be seen to be equivalent to a change of almost $70 billion in the budget balance, moving it from a deficit toward a surplus. Such a large amount of fiscal restraint during 1981 would retard improvement in the unemployment rate, but at the same time it would contribute to the goal of reduced inflation.

FISCAL POLICY OPTIONS

In considering fiscal policy for fiscal year 1981, the Congress must keep in mind both the short-run and the long-run problems of the economy. The short-run problem is a sharp recession with continuing high inflation. The long-run, more basic problem is an inflation-prone economy with low productivity growth. What is needed, among other things, to improve productivity is increased saving and investment. There is a risk, however, that efforts to speed up the recovery will emphasize consumption and make the economy less productive in the long run. Ideally, of course, the Congress should strive to design a policy that enhances the recovery without escalating inflation and improves the prospects for investment and productivity. But it is very hard to do that.

Thus, the Congress is faced with a difficult series of choices:

CONTINUE RESTRICTIVE BUDGETARY POLICY

First, is the restrictive budgetary policy of the first resolution still appropriate, or should the budget be more stimulative? Continuing restraint would hold down the deficit and continue the battle against inflation, but it would retard recovery from the recession. Additional stimulus, whether in tax cuts or in spending increases, would enhance the recovery, but it would risk more inflation.

Second, if the Congress wants to alter the budget to offset recession, what policies are available? Basically, there are three: spending could be increased; individual taxes could be cut; or business taxes could be cut.

SPENDING INCREASES

Increased spending programs can be targeted to hard-hit areas, but implementation of spending increases is likely to be slow. The danger is that such programs would take effect when recovery was well on the way, perhaps add to inflation, and do nothing to enhance productivity. An individual tax cut stimulates spending quickly, but it does not directly improve productivity. A business tax cut can increase investment, but it acts slowly and does not relieve the burden of higher income and social security taxes on lower- and middle-income people.

TAX OPTIONS

Third, if the Congress were to decide on a tax cut, when should it be enacted and how big should it be? The timing of enactment is very difficult, as no one needs to tell you, since the need for a prompt response to the worsening economic situation has to be weighed against the time needed to design an appropriate response in a complex situation. A most important factor for the Budget Committees is the size of the revenue loss in 1981 and future years. Various tax cuts have very different outyear effects. A tax cut with large future revenue losses could foreclose budget options and make it far more difficult to achieve budget balance as the economy recovers.

In view of the current focus on tax options in the Congress and the administration's suggestion that a cut may be needed at some point, what follows is a brief summary of the pros and cons of some of the principal tax options now under consideration.

PERSONAL TAX CUTS

Among the major personal tax cut options now being discussed are an income tax credit equal to some portion of social security taxes; a 10 percent across-the-board reduction in personal income tax rates; and a tax cut designed to offset the effects of inflation by increasing personal exemptions, the standard deduction, the earned income credit, and by widening tax brackets.

CREDIT AGAINST SOCIAL SECURITY TAXES

First, an income tax credit equal to 10 percent of social security payroll taxes would reduce revenues by about $10 billion in fiscal year 1981 and about $25 billion in fiscal year 1985, as shown in table 3. Both employers and employees would benefit, but those who pay no social security taxes, such as Federal workers and the elderly, would not. A 10-percent credit would approximately offset the social security tax increase scheduled for this January. The tax savings would be concentrated on those with low and middle incomes and on two-earner families, as can be seen in table 4.

TABLE 3.—REVENUE LOSSES FROM PERSONAL TAX CUT OPTIONS, FISCAL YEARS 1981–85

[In billions of dollars]

	1981	1982	1983	1984	1985
10 percent credit against social security taxes	10.3	16.9	19.3	21.8	25.4
10 percent reduction in income tax rates	19.8	35.4	41.8	49.3	58.1
Inflation-offsetting tax cut	14.6	17.2	20.3	24.0	28.3
Illustrative effects of components of an inflation-offsetting tax cut: [1]					
10 percent widening of income tax rate brackets	10.3	18.4	21.8	25.7	30.3
$100 increase in the $1,000 personal exemption	2.9	4.7	4.9	5.0	5.2
$100 to $200 increase in the standard deduction (zero bracket amount) [2]	.9	1.5	1.6	1.7	1.8
1 percent increase in the earned income credit [3]	1.0	1.1	1.0	.9	.9

[1] These components of an inflation-offsetting tax cut do not add to the total; they represent only illustrative changes in the various tax provisions.

[2] Increase from $2,300 to $2,400 for individuals, and from $3,400 to $3,600 for joint returns.

[3] Increase from 10 to 11 percent of first $5,000 of earnings, with phase-out at $14,000 of earnings rather than at $10,000.

TABLE 4.—DISTRIBUTION BY INCOME CLASS OF TOTAL TAX SAVING FROM PERSONAL TAX CUT OPTIONS

[In percent]

	Share of total		Share of tax savings from					
Expanded income class	Number of taxable returns	Tax payments under current law	10 percent social security credit	10 percent rate cut	10 percent bracket widening	$100 personal exemption increase	$100 to $200 standard deduction increase [1]	EITC increase [2]
0 to 10	26.6	3.1	14.6	4.8	7.4	11.4	26.0	65.4
10 to 20	36.6	19.6	29.8	21.3	20.9	29.4	41.5	34.4
20 to 30	22.1	24.7	30.2	25.0	25.1	28.7	23.3	.1
30 to 50	11.3	24.0	19.8	24.5	26.4	20.9	7.8	.0
50 to 100	2.8	14.6	4.6	14.4	14.8	7.6	1.2	.0
100 plus	.6	14.1	1.0	10.0	5.4	2.0	.1	.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[1] Increase from $2,300 to $2,400 for individuals, and from $3,400 to $3,600 for joint returns.

[2] Increase from 10 to 11 percent of first $5,000 of earnings, with phase-out at $14,000 of earnings rather than at $10,000.

Note.—The table reflects 1979 income levels. Details may not add to total because of rounding.

A 10-percent tax credit against social security taxes would have approximately the same economic effects as a rollback of the scheduled 1981 payroll tax increase. Because employers' wage costs would be reduced, inflation would be slightly lower than now projected—the Consumer Price Index would be perhaps 0.2 percentage points lower in 1982.

ACROSS-THE-BOARD REDUCTION IN PERSONAL INCOME TAX RATES

Second, a 10-percent cut in personal income tax rates would reduce revenues by about $20 billion in fiscal year 1981 and about $58 billion in fiscal 1985. More of the tax savings would go to high-income taxpayers and less to low-income taxpayers than under a social security tax credit, as shown in table 4.

By reducing marginal tax rates, a tax cut of this kind could increase work and saving incentives, since individuals would be able to keep a larger share of their income from additional work and investments. These effects would probably not be large, however, and they would take place only over a long period. In the shorter run, the tax cut would add to consumer spending and might increase inflation slightly.

INFLATION-OFFSETTING TAX CUT

A third option is an inflation-offsetting tax cut. A tax cut designed to offset the effects of inflation on the individual income tax would widen the rate brackets and increase personal exemptions, the standard deduction, and the earned income credit. A cut of this kind would reduce fiscal year 1981 revenues by about $15 billion and fiscal year 1985 revenues by about $28 billion, as shown in table 3. This kind of tax cut would assure that those whose incomes increased at no more than the rate of inflation would not have to pay a higher share of their incomes in taxes.

BUSINESS TAX CUTS

The major business tax cut options currently under discussion include: Increases in depreciation deductions; reductions in the corporate tax rate; and increases in the 10-percent investment tax credit.

THE 10–5–3 PLAN

The first set of options deal with depreciation. The 10–5–3 plan, formally known as the Capital Cost Recovery Act, would significantly increase deductions for depreciation by establishing a simplified depreciation system with much shorter useful lives for most business assets. These higher deductions would encourage additional business investment by helping to offset the effects of inflation on allowances for depreciation. The revenue losses from this proposal would be very large in the outyears, reaching an estimated $46 billion in 1985 and over $80 billion by 1988, as shown in table 5. The revenue losses in the early years are substantially lower, partly because the plan would be phased in over a period of 5 years. This phase-in, however, could significantly reduce investment in the early years if businesses postponed investments to wait for the more favorable tax treatment in later years.

TABLE 5.—REVENUE LOSSES FROM BUSINESS TAX CUT OPTIONS, FISCAL YEARS 1981–85

[In billions of dollars]

	1981	1982	1983	1984	1985
10–5–3:					
With phase-in	$3	$9	$16	$28	$43
Without phase-in	5	18	32	41	46
Ullman (no phase-in)	2	8	12	14	14
1st-year plan [1]	13	31	19	7	0
Expansion of ADR range to 40 percent		2	4	6	8
Increase in 10 percent investment tax credit to 11 percent	1	1	1	2	2
Extension of 10 percent investment tax credit to structures	2	3	3	3	4
Reduction in top corporate tax rate from 46 to 44 percent	2	4	5	5	6

[1] Includes repeal of investment tax credit. Without repeal, the peak revenue loss in 1982 would be $54 billion.

Some types of business investment would benefit substantially more under 10–5–3 than others. For most types of equipment, for example, 10–5–3 in combination with the investment tax credit would be more beneficial than not taxing the income from these investments at all. The 10–5–3 plan would increase the rate of return for industrial and commercial buildings, though not by as much as for equipment. Residential rental buildings are not included in 10–5–3, and thus would not benefit at all.

These differences in the treatment of different types of investment could reduce the favorable effects of 10–5–3 on longrun investment and productivity, since they could divert investment resources away from their most productive uses.

ULLMAN DEPRECIATION PLAN

An alternative depreciation plan proposed by Chairman Ullman of the House Ways and Means Committee has the same general objectives as 10–5–3. It would shorten useful lives for all equipment and buildings by at least 35 percent. It would establish four useful life categories for equipment—3, 6, 9, and 12 years—and three for buildings—15, 25, and 30 years. The mechanics of calculating depreciation would be greatly simplified by lumping all assets in each category together, rather than requiring that a separate depreciation account be kept for each asset. The revenue losses from the Ullman plan would be much lower in the outyears than those of 10–5–3, peaking at a level of about $14 billion in 1985.

JORGENSON FIRST-YEAR PLAN

Finally, with respect to depreciation, there is the Jorgenson first-year plan. The first-year plan proposed by economist Dale Jorgenson would simplify the calculation of depreciation and would allow the discounted value of all future depreciation deductions for equipment and buildings to be taken in the first year, rather than being spread out over the life of the asset. The first-year plan would thus eliminate any erosion of depreciation deductions by inflation.

The revenue losses from the first-year plan would be very large in the first year or so, since the entire amount of depreciation on new assets that would normally be spread over many years would be taken in the first year. The revenue losses would decline sharply, however, in the later years. The pattern would thus be very different from that of 10-5-3.

INCREASE INVESTMENT TAX CREDIT

An alternative way of stimulating business investment in equipment would be to increase the investment tax credit. Increasing the credit from 10 to 11 percent, for example, would result in a revenue loss of about $1 billion in 1981, increasing to about $2 billion by 1985. Many firms would not be able to use the additional credit to offset taxes in the year eligible investments are made, however, since their tax liability is less than the credit. In the aggregate, only about half of the extra 1 percent credit could be claimed in the first year.

Increasing the investment tax credit would increase the relative tax disadvantage of investments in buildings, since buildings are not eligible for the investment tax credit. Extending the credit to commercial, industrial, and residential rental buildings would cost $2 billion in lost revenue in 1981 and about $4 billion by 1985.

CORPORATE TAX RATE CUT

A third option would be a cut in the corporate tax rate. Reducing the top corporate tax rate from 46 to 44 percent would result in tax savings for all incorporated businesses. While only about 13 percent of all businesses are incorporated, they account for about 85 percent of all business income. The revenue losses from a corporate rate cut would not grow as much in future years as those under acceleration depreciation. These losses would rise from about $4 billion in the first year to about $6 billion in 1985.

By reducing the top marginal rate on business investment, a corporate rate cut of this kind would encourage additional investment. The stimulus to investment in plant and equipment could be less, however, than from increases in depreciation or an investment tax credit with the same revenue loss, since the tax saving from a corporate rate cut occurs whether or not a firm makes new investments.

BASIC TRADEOFFS INVOLVED IN TAX OPTIONS

In conclusion, Mr. Chairman, let me emphasize again the basic tradeoffs that are involved in tax policy. Consumption oriented individual tax cuts can help the return to full employment in the short run, but they may worsen inflation and use up some of the revenues that could otherwise be used for longrun business tax cuts. Business tax cuts take effect more slowly, and may be more difficult to agree on in the next few weeks, but they do significantly enhance future economic growth. Finally, as always with budgeting, resources are scarce, and large revenue losses in future years may foreclose many tax and spending options and make it more difficult to balance the budget.

Thank you, Mr. Chairman.

Chairman HOLLINGS. Thank you very much, Dr. Rivlin.

I notice, in your statement, the figure used for the increase in revenues: "These three factors alone account for about $37 billion of the $80 billion projected increase in current law revenues for 1981." I am trying my best to get on the same speaking plane with respect to the increased revenues or, as characterized by some in this Congress, increased taxes.

Can that $80 billion be broken down very easily, or would you do it for the record later on? I want to know how you arrive at $80 billion. I have seen some come to $60 billion, and some go to even higher figures.

Dr. RIVLIN. We can certainly supply that for the record, Mr. Chairman, and compare it to other estimates, if you have some you would like us to compare it to.

Chairman HOLLINGS. All right.

[The following was subsequently supplied for the record:]

Total federal government revenues are projected by CBO to increase $79 billion between fiscal year 1980 and fiscal year 1981—from $517 billion in 1980 to $596 billion in 1981.

About half of this increase, $39.6 billion, is attributable to administrative and legislative initiatives, and to the increase in individual income taxes caused by the interplay between inflation and the progressive income tax structure, which leaves many taxpayers paying more taxes on the same real income. This last effect is often called bracket creep.

The breakdown in the increase in revenues between fiscal years 1980 and 1981 attributable to these factors is shown in the following table.

TABLE 1.—*Composition of fiscal year 1981 revenue increase*

[In billions of dollars]

Administrative and legislative initiatives and individual income taxes:	
Windfall profit tax	$13.7
Social security taxes from increase in rate and income base	9.8
Strategic petroleum reserve program (Public Law 96-294)	.6
Administrative cash management initiatives (income and FICA tax collections speedup)	2.5
Bracket creep	13.0
Subtotal	39.6
Revenue increase due to economic activity (by type of tax):[1]	
Individual income tax	19.6
Corporate income tax	9.2
Social insurance taxes	10.9
Excise taxes	−.8
Estate and gift taxes	.2
Customs duties	.6
Miscellaneous taxes	−.3
Subtotal	39.4
Total	79.0

[1] This portion of the increase in Federal Government revenues in 1981 can be attributed to the rate of economic activity. CBO expects that 1981 will be a year of modest recovery with real output increasing 1 percent over its 1980 level. The labor market will remain weak throughout the year, with the unemployment rate close to 9.0 percent. The inflation rate for the year is projected to be 8.8 percent (annual percentage increase in the gross national product deflator).

DELAY PAYROLL TAX INCREASES FOR SOCIAL SECURITY

Chairman HOLLINGS. Jumping over to the social security and the matter of a tax cut, there is the argument about waiting, but, seemingly, everyone includes in their recommendations for serious consideration offsetting the impact of the payroll tax increases in January for social security.

If we delayed—and assume we do it deliberately—so if we do delay it until next spring, say in March, but the payroll taxes already commence and are collected and paid in January, February, and March while we are being all that deliberate. Is there a case to be made that if you are really going to do the social security rollback you ought to do it now before we discombobulate and confuse all the records and payouts and bureaucracy necessary to go ahead for that increase, or not? What is your comment about that?

Let us assume I am going to do that. Is it wise to go ahead and do that before the Congress adjourns here this November?

Dr. RIVLIN. There would be some additional complexity involved in allowing the tax rate increase and then changing it, but I don't think that concern should be overriding. I would think the Congress should schedule any tax change based on the type of tax and the timing it thinks best meets the needs of the economy. The Congress should not worry too much about the mechanics of putting the change into effect.

Chairman HOLLINGS. You do not find the mechanics giving us too much difficulty if we delay until next March?

Dr. RIVLIN. I don't think it would be that difficult. The mechanics of a payroll tax increase are fairly simple.

There is, of course, the additional political problem of whether people will be worried and confused if their taxes go up and then go down, but that is a different question.

WEAK RECOVERY PROJECTED FOR 1981

Chairman HOLLINGS. Why is such a weak recovery projected for 1981? In your statement you say, "followed by a relatively weak recovery." Everyone talks in terms of high unemployment, 8.5 percent average for the entire calendar year 1981. Whether the body politic will sit steady in the boat and allow that to occur without all kind of countercyclical and public works and stimulative programs is going to be a political problem for us. Economically, why the weak recovery?

Dr. RIVLIN. The growth in the economy is expected to be relatively weak because there is no obvious strong sector to lead us out of the recession rapidly. There is certainly hope that housing and automobiles will bounce back, CBO is forecasting a sizable increase in housing activity next year. But we shouldn't expect to have an especially strong increase in automobiles until the industry production has adjusted to the demand for smaller models. There just does not seem to be an obvious reason for expecting a rapid increase in output in the next year or so, although what might be described as a modest recovery is anticipated by everyone.

Chairman HOLLINGS. Because we do not have any obviously strong sector, like housing, automobiles or steel; you just cannot see the industries. It is not, then, an edict of the Government? There is not much we can do about it; is that what you are saying?

DUAL EFFECT OF RESTRICTIVE FEDERAL BUDGET

Dr. RIVLIN. The Government has something to do with it. As I said in my statement, if one does keep the current budget policy—and that is the assumption underlying our forecast—then the fiscal 1981 Federal budget will be quite restrictive; it will be moving toward surplus; it will be reducing the deficit in a very weak economic situation. Federal spending will be increasing at a slower rate than in 1980 and revenues will be rising in 1981 at a higher rate. So the Federal sector by itself will be restraining the vigor of the recovery.

Chairman HOLLINGS. It will be restraining inflation?

Dr. RIVLIN. That is correct, and that is the difficult tradeoff.

Chairman HOLLINGS. If I were on a political talk show and you asked me, I would say I was not restraining the recovery; I was trying to restrain inflation. Would I be accurate in that statement?

Dr. RIVLIN. Yes.

Chairman HOLLINGS. Well, I would think so. Would you recommend something else to strengthen the recovery and accelerate the recovery and make for a quicker and firmer recovery?

Dr. RIVLIN. I am not in the business of making recommendations, but you are certainly correct that a restrictive Federal budget has both effects. It was designed—to restrain inflation by holding down public spending, and it is having that effect. But, by the same token, it restrains the recovery in output and employment.

STIMULATED ECONOMY COULD CAUSE HIGHER INFLATION AND CONSEQUENT RECESSION

Chairman HOLLINGS. Well, could it be, then, if I stimulated the economy by putting in additional spending programs, that I could perhaps cause a stronger 1981 recovery, but I would be heading again in 1982 and 1983 for higher inflation and a deeper recession?

Dr. RIVLIN. Yes. The effect of stimulating the economy in 1981 would clearly be to risk higher inflation in 1982 and 1983 and possibly a consequent recession after that.

NO IMMEDIATE SOLUTION FOR UNEMPLOYMENT

Chairman HOLLINGS. Specifically, as I understand the economists to be saying, there is nothing I can do politically, or the Budget Committee or the Congress can do, between now and November about this high unemployment, and the enemy is still inflation. And the reason there is nothing I can do is that a mistake was made back in, let us say, in 1978 and 1979; I should have had a more restrictive spending program at that particular time, and having made the mistake in 1978 and 1979, there is little I can do about it here in 1980. Is that correct?

Dr. RIVLIN. That is substantially correct. There is probably nothing the Government can do to change unemployment in the next few months. When a recession starts and when unemployment begins to rise, it is very difficult to get it down quickly.

Chairman HOLLINGS. There is nothing to be done between now and when we break in October for the election, and we are faced with almost 9 percent unemployment on November 4 and we are supposed to be reelected. [Laughter.]

Dr. RIVLIN. Well, the forecasts could, as Senator Bellmon suggests, turn out to be too pessimistic. The unemployment rate might not rise that fast. But I don't think there is very much the Government can do now to affect what will happen to the unemployment rate over the next few months.

Chairman HOLLINGS. Let me yield to Senator Bellmon.

IMPACT OF CHANGING MONETARY POLICY ON ECONOMY

Senator **Bellmon**. Thank you, Mr. Chairman.

Dr. Rivlin, I want to suggest to you a rather sinister scenario that might have happened—probably did not, but maybe it could have—and that is that one economist after another predicted a recession for months and months and months and a recession refused to materialize, and I have a picture in my mind of a delegation of economists calling on Chairman Volcker and saying, "Mr. Chairman, our professional reputations are at stake." [Laughter.]

"We have been calling for a recession and it refuses to happen, so please help us." [Laughter.]

And I think he did it with a vengeance.

Now, you have talked here this morning about fiscal policy, but, really, our problem, I think, relates a lot to monetary policy. It was the high interest and the credit restraints that the Fed put in place back in March, that precipitated this very considerable decline in the state of our economy in recent weeks.

Now, the monetary policy has been dramatically relaxed in recent weeks, and I do not see any reference here to what that it is going to do to our economy. Interest is now down; money is available; the money supply is starting to grow again. They had it almost choked off for a good long while. What impact will a change in monetary policy have on our economy?

Dr. **Rivlin**. I think it will have the effect one would expect it to have, but not immediately. Housing will come back; it is showing signs of doing that already, but it takes time, for easy credit conditions to translate into increased construction activity.

Senator **Bellmon**. Right.

Dr. **Rivlin**. And there will eventually be a pick-up in spending for consumer durables, which are affected by——

DELAY IN RESUMPTION OF CONSUMER SPENDING QUESTIONED

Senator **Bellmon**. Now, it did not take long, when they raised the interest, to shut off spending. Why will it take so long to get it started back again?

Dr. **Rivlin**. I think——

Senator **Bellmon**. I think the demand is still there. People who wanted a house still want houses. People who wanted a car still want a car, probably want it more than ever now.

IMPACT OF CREDIT CONTROLS AND RISING INTEREST RATES ON CONSUMER SPENDING

Dr. **Rivlin**. It is certainly true that last year economists were predicting a recession and it did not quite happen. The economy slowed down a lot last year, but consumers went on spending at very high rates; they really refused to acknowledge that their real incomes were declining. They were dipping into savings and continuing to spend at surprisingly high rates, partly in the expectation of more inflation and, presumably, partly for other reasons.

When the Federal Reserve did make additional, quite dramatic moves to tighten credit and reduce consumer spending and to put controls on consumer credit, there was a dramatic turn-around in consumer spending. Whether it was all attributable to the Federal Reserve actions is very difficult to say. I think most economists would say that this turnaround was bound to happen sooner or later, and that the final impetus was the credit controls and rising interest rates.

But once the slowdown has started, it is not obvious that it can turn around as quickly as you suggest. The past experience would lead one to expect severed consequences. First once a recession gets started and the downturn is very rapid, consumers get quite cautious about spending and will not come back very quickly. Furthermore, the downturn is likely to spread to other sectors. Third, investment will not be as heavy, in view of falling sales, as it would otherwise have been.

CONSUMER SPENDING UNABATED

Senator **Bellmon**. I have to relate to you a personal experience. I was home during the recess and needed to buy a new tractor. I went to the dealer to get one, and he could find only one tractor in the whole State of Oklahoma for sale of that particular brand. Now, to me, that does not show consumers are not spending; they are grabbing everything they can get their hands on, at least in our area.

Dr. **Rivlin**. One thing that is, making this recession very difficult to access is that it is unusually concentrated geographically. If you come from Michigan or northern Indiana or Ohio, your view of the situation is very different than if you come from Oklahoma, and for very real reasons.

Senator **Bellmon**. That is agreed, and that is largely due to the fact that when interest went so high people quit buying cars and quit buying houses. They still want cars; they still want houses, and interest is now down to about half of what it was. So I cannot imagine why people will not some day, when the heat lets up a little, decide to go shopping.

Dr. **Rivlin**. I think they may. But if you do not have a job or if your brother-in-law does not have a job, you may be more cautious about buying a new car at any interest rate—at least that is the experience of past recessions.

FISCAL POLICY FOR 1980 ERODED BY UNCONTROLLABLE EXPENDITURES

Senator **Bellmon**. Well, I think people will begin to realize pretty soon that one way you get a job is to buy things, and I think people are very eager to do that.

Let me get to another point, getting away from the monetary side of it for a moment. In your statement, you describe fiscal policy in 1980 as expansive. Our first budget resolution for 1980 provided outlays of $532.0 billion. Now, if we had been able to stick to that target for an increase of fiscal year 1980 over 1979, we would have had a 9.8-percent increase.

Now, is 9.8 percent really expansive, or would you think of that as being restrictive in light of the rate of inflation that we are experiencing? The fact of it is that the increase in spending really is not 9.8 percent. As I understand it, it is closer to 18 percent.

Dr. **Rivlin**. That is right.

Senator **Bellmon**. So it is not our resolution that is expansive; it is the expenditures that go on outside our control. Is that right?

Dr. **Rivlin**. The original 1980 resolution was not particularly expansive, but spending has risen considerably above the original targets, as you point out, for a number of reasons. Part of the rise relates to the worsening economic situation. Part of it relates to more rapid defense spending than was anticipated. Some of it relates to acts of God, like volcanic eruptions, that were not predicted when the first resolution for 1980 was passed.

STABILIZE ECONOMIC ROLLER COASTER

Senator **Bellmon**. Now, our 1980 spending, as I understand it, is nearly $50 billion more than in our first budget resolution for 1980. Is there a danger that if we now become expansive in 1981 that we may have a similar increase in spending above what we anticipate?

Dr. **Rivlin**. Yes, there is always that danger. The economy could be worse than predicted, which would raise unemployment compensation and other expenditures. It could also be better, which would lower those expenditures. But there is certainly a risk on the upside.

Senator **Bellmon**. That is the thing that troubles me most. If we here in the Budget Committee now yield to the temptation to either make room for a tax cut or go in for some spending scheme, we are simply going back on this roller coaster. Very quickly, we will see inflation rise; interest will go up. Then we will have the Fed tightening down again and go back into a recession.

It seems to me that somehow or other, we have to figure a way to stabilize this process; it looks to me like that may be our greatest responsibility.

That is all I have, Mr. Chairman.

Chairman **Hollings**. Senator Chiles.

IMPACT OF RATE STRUCTURE ON BRACKET CREEP

Senator **Chiles**. Doctor, I hear about bracket creep all the time and I have repeated it as much as anyone else has. I notice that you have one proposition in there that if you sort of held people kind of harmless from the bracket creep—normally, as you are being pushed up in the brackets, you are actually getting more income by virtue of inflation or some other reason, depending on where your income comes from.

Is it our rate structure that would have you paying more and actually getting less from what you are able to keep? In other words, to get up into a higher bracket, you have to have more income.

Dr. **Rivlin**. That is right, but not necessarily more real income.

Senator **Chiles**. Because it is buying less.

Dr. **Rivlin**. If your income is increasing at exactly the same rate as the prices of the things you buy—for example, if your income is going up at the same rate as the Consumer Price Index—then you are no better off. You cannot buy any more than you could before, but you may be paying more taxes. Because our tax structure is not formulated in terms of real income; it is formulated in terms of nominal dollars, so that you are pushed into a higher tax bracket and you have less real take-home pay. Your money does not go as far in the supermarket as it did before.

Senator CHILES. So, the table that you have in there that talks about a tax cut that would just be to hold people more harmless—that is the effect of that; people would not be getting a windfall out of that.

Dr. RIVLIN. That is correct, if it is appropriately designed to reflect the real change in their incomes.

WINDOWS OF OPPORTUNITY FOR BALANCING THE BUDGET

Senator CHILES. Some of the testimony we were hearing yesterday was talking about our need to try to balance the budget once during the cycle. Part of what I got from the testimony yesterday in listening to the economists is that it is like windows that come along, and some of them were saying that the next window for balancing the budget would be 1985.

It is kind of like Haley's Comet in a way; I mean, it is going to come around every 50 years. Maybe that is what the public kind of thinks.

What do you see as the next window? You know, we went through this exercise and a lot of us felt like we were doing something. We told the troops that we were doing something and that we had an opportunity to balance the budget if we would cut the current level of spending and if we would get into the reconciliation. Now, we see that that is all gone, because the economy did not behave as we were hoping; I guess all we had was a hope that it would behave.

What do you see as the next window?

Dr. RIVLIN. In the first place I think you were victims of very bad luck as well as errors in forecasting. The efforts that were undertaken to balance the 1981 budget were not just an exercise; they were very real. Although the economy has conspired against you and although you have not balanced the budget, you have, in fact, if you stick to that budget plan, slowed down the rate of increase in Federal spending very considerably. That is a very real effect.

It is very hard to say when the next possible balanced budget would be. I would not be so pessimistic as to say that it could not happen until 1985. I do not see why it should take that long. I should think that with a reasonable recovery——

Senator CHILES. But you are not predicting a reasonable recovery.

Dr. RIVLIN. Well, with something like we are predicting, if such a recovery continues and the economy goes upward, it should be possible to design policies that would balance the budget in, if not 1982, certainly by 1983.

TAX CHANGES CONSISTENT WITH EFFORTS TO BALANCE THE BUDGET

Senator Chiles. What kind of tax cut should we have if we were going to balance the budget in 1983 or 1982?

Dr. Rivlin. If you really wanted——

Senator Chiles. If you were designing a balanced budget for me for 1983, what kind of tax cut would you include?

Dr. Rivlin. One might argue that the best way to maximize the chances of balancing the budget would be not to have a tax cut, if a balanced budget is the objective.

Senator Chiles. What kind of unemployment rate would you have?

Dr. Rivlin. On the assumption of no tax cut for 1981, which is the assumption that our forecast is based on, we are saying that the unemployment rate would stay in the high eights through 1981. If the recovery continued, the rate would presumably come down after that.

We could look at the longer run question of what tax changes would be consistent with balancing the budget on certain assumptions in more detail for the record, if you would like, Senator Chiles.

[The following was subsequently supplied for the record:]

Question. What tax changes would be consistent with balancing the budget in 1982 or 1983?

Answer. The answer depends on several important factors.

The first is the economic growth targets. The CBO economic forecast does not extend beyond calendar year 1981. The Committee plans to use a set of assumptions for 1982–1985 that contain a 4 percent real rate of growth, with no cyclical variations.

The next factor is the strength of demand in the nonfederal sectors of the economy. Other things being equal, stronger nonfederal demand (that is, faster growth in consumption, investment, state and local government purchases, and net exports) reduces the need for tax cuts to keep the economy growing at the assumed rate, and would mean the budget deficit could be reduced more quickly.

Monetary policy also affects the result. Assuming a fixed target for economic growth, an expansionary monetary policy would diminish the need for tax cuts in order to meet the growth targets.

Finally, the composition of the tax changes affects the size of the required tax cuts. The magnitude and timing of the economic effects of tax cuts can vary.

As part of the preparation for the second resolution markup, we have estimated the tax cuts consistent with the Committee's long-run economic growth targets. The projections assume relatively strong nonfederal demand, accommodative monetary policy, spending at the level of the first resolution as reestimated, and generalized income tax cuts to individuals (two-thirds) and corporations (one-third). As shown in the table, the budget would be near balance in fiscal year 1983. I want to reemphasize, however, that the range of uncertainty on the projection would be as high as plus or minus $30 billion.

BUDGET AND ECONOMIC FORECAST AND PROJECTIONS

[By fiscal year]

	1980	1981	1982	1983
Outlays (in billions of dollars)	580.3	629.1	706.8	775.6
Revenues (billions of dollars)	517.0	601.0	680.5	766.8
Deficit (in billions of dollars)	−63.3	−28.1	−26.3	−8.8
Tax change from "Current Law Adjusted" (in billions of dollars, gross[1])			−16.1	−42.0
Inflation rate:				
CPI (in percent)	13.6	9.6	9.2	8.4
GNP deflator (in percent)	9.0	9.0	8.7	8.4
Unemployment rate (fiscal year average, in percent)	7.0	9.0	8.7	7.9
Real GNP growth (in percent)	−.4	−.7	3.5	4.0

BUDGET AND ECONOMIC FORECAST AND PROJECTIONS—Continued

[By fiscal year]

	1980	1981	1982	1983
Nominal GNP (in billions of dollars)	23.1	23.1	23.1	22.5

[1] For fiscal years 1982 and 1983, consists of general tax changes approximately consistent with achieving the economic assumptions shown. Revenues under "current law adjusted" do not include the general tax cuts of $16.1 billion and $38.3 billion assumed by the Senate for those years in the first resolution, since these tax policies are a major issue for reexamination, but do include revenues from the Senate-passed reconciliation bill and other minor assumptions.

INSURE CAPITAL INVESTMENT FOR FAILING INDUSTRIES

Senator **Chiles**. I think I would like to see that; I do not know if anybody else would. I would like to determine what could be possible with that.

I am concerned that we are looking at certain areas of our economy now that appear to be very sick—autos, steel, and some of our other heavy industries. When we look at the current problems in trying to raise capital for those areas and for the competing areas that will be out there, such as coal and all of the synthetic energy that we are trying to get on line—those other areas that are going to be competing for capital—how are we going to be able to insure that we will be able to get enough capital to reindustrialize the heavy industry in this country which, as I understand it, is very, very antiquated now? We are going to have to do that or face greater problems in the future than we are facing now.

TAX SYSTEM ENCOURAGES CONSUMERS TO INVEST PRIMARILY IN HOUSING

Dr. **Rivlin**. There are several approaches to this. First, you are absolutely right that certain industries, including steel and automobiles, appear to have extremely heavy capital requirements for the next few years if they are going to stay competitive in the world market. That means that the economy is going to have to generate substantial savings as it moves ahead.

To attract more savings and more money into investment generally, some of the tax changes that make the rate of return higher and encourage investment are certainly worth talking about. Accelerated depreciation is an example of such a change. There may also be special problems of certain major industries that would not be helped by more general solutions.

One possibility that I think bears more looking at is whether, on balance, we in the United States are putting too much of our investment into housing and not enough into other types of investment. Our tax system is very oriented toward encouraging consumers to invest in housing rather than in other forms of investment.

Senator **Chiles**. You mean because of the interest deduction in housing and the capital gains that you are able to receive?

Dr. **Rivlin**. That is part of it.

Senator **Chiles**. We are not encouraging much investment in rental housing, given the stock that we have out there.

Dr. **Rivlin**. No; our system is essentially stacked against that. We should think about whether we are not making home ownership too attractive and encouraging too much investment in housing and perhaps not channeling enough saving into other things.

Senator CHILES. Well, we have a tremendous demand out there, and now we have cut off housing for a while. We have lost a million in the stock of housing, and so you have that pent-up demand that is out there that is going to come back and hit us next year, which, some of them were saying in their statements yesterday, was going to cause the cost of housing to spurt up again because of that demand. So, that is what we have done with housing which has caused it to be so highly inflationary.

Dr. RIVLIN. That is right.

Senator CHILES. I do not know if the answer is to try to take away from housing.

Dr. RIVLIN. I do not think there is any single answer. But, clearly, as you look across the things that the Government can do to encourage saving and investment, that is one set of things that might be looked at.

Chairman HOLLINGS. Senator Domenici.

TAX CHANGES TO INCREASE PRODUCTIVITY AND CAPITAL INVESTMENT

Senator DOMENICI. It seems to me that if we are concerned for the long term—and you did express some genuine concern that many decisions are being made short term and that we have to look at some long term—it seems to me that everyone who has talked to us, including you, has indicated that we have to make some changes in our tax structure, supply side-oriented, aimed at productivity, capital formation and investment.

I guess I am arriving at the conclusion that if that is really necessary for healthy, long-term recovery, we ought not to continue to hold that kind of tax change hostage any longer to a balanced budget, since, as a matter of fact, it was something that we used to try to restrain spending. But we find ourselves in the position that because of other economic factors, including the Federal Reserve's actions which may have been necessary but brought far more than anyone expected in terms of recession and in terms of stagnation—it seems to me that we ought to get on with tax changes that are moving in the direction of increasing our productivity and capital investment.

If there is one thing that comes through, it is that you were saying that that has to happen. At the same time, you are saying it is not going to help this coming year, as you see it, because it is mostly long term. But why should we wait any longer when the consensus is that that must be done?

Dr. RIVLIN. Well, I think there is a strong consensus that we need more saving and investment and that something must be done to the tax structure in that direction fairly soon.

Senator DOMENICI. That would not be inflationary, would it?

Dr. RIVLIN. No, it probably would not be as inflationary as tax cuts to spur consumption, especially over the longer term. But there is not a consensus on exactly what to do.

Senator DOMENICI. I understand that.

Dr. RIVLIN. It is very complicated. So the argument that one should take some time to think through very carefully the alternative business tax changes, and that maybe that cannot be done in the next month, has some weight.

INFLATIONARY ASPECT OF TAX CHANGES

Senator **Domenici**. My good friend, Senator Bellmon, is saying, "We have a restrictive budget; even if it did not come out balanced, still do not rock the boat." I think his prime concern is that we may do things that will slightly increase unemployment, but will dramatically affect inflation, if I am reading him correctly.

Now, I am merely asking, are there not major tax changes, the precise nature of which we do not agree upon today, that are directed at productivity, capital formation, and incentives to save, that would not be inflationary in 1981?

If we did it a year ago, we would be feeling some effect in 1981. If we do not do it now, we might not be feeling the effect until 1982 or 1983. You were saying that those changes, if tailored properly, would not be inflationary. Is that correct?

Dr. **Rivlin**. Over the longer term, business tax cuts encourage investment in plant and equipment, helping to boost productivity growth and reducing the inflationary consequences of higher wage demands. To the extent that productivity growth is desirable, and I think it is, one could make a strong case for the Congress giving very serious consideration to business tax changes some time in the next year or so.

Senator **Domenici**. The reason you are saying the next year or so, if I understand you correctly, is because you think there must be time to deliberate the best way to do it. If you had the best way in front of you today, you would not hesitate to say that that would be a good policy for this country, even if it added to the $29 billion deficit, would you?

Dr. **Rivlin**. That is sort of a loaded question. If we really knew exactly what to do, we would do it.

ALL TAX CUTS WOULD NOT BE INFLATIONARY IN 1981

Senator **Domenici**. Well, OK. We have had the year to think it through, hypothetically, and the year is over and it is before us and there is a productivity-oriented, capital formation-oriented package before the Congress, and it is $20 billion in size. Now, my question is, that would not be inflationary if we went ahead and passed it now, would it? We are going to have to do it sooner or later, right?

Dr. **Rivlin**. Perhaps, but you would have to weigh, against the desirability of such a package, other arguments—for example, about the competing claims of consumers, the fact that other taxes are going up, and the desire to hold down the budget deficit in the long run.

Some of the business tax plans have very large revenue losses in the outyears, and you would have to think about whether you would be endangering other goals, such as a balanced budget in, say, 1985.

Senator **Domenici**. I am not really trying to make this a political issue, and I hope you are not. I am not advocating anybody's tax plan. Mr. Greenspan did that yesterday; I am not doing that.

I really wonder if we are not in a catch-22 with reference to productivity. If we are going to have a deficit anyway, if we want to wait around to study it longer and to come closer to a balanced budget before we do it, are we not just putting off the point in time when we can have a higher level of productivity to the extent that tax laws can effect it?

DETERIORATING ECONOMIC CONDITIONS STRENGTHEN CASE FOR TAX CUT

Dr. **Rivlin**. Let me put it a different way. One might reason that the worsening economic condition has strengthened the case for some kind of a tax cut, and thus seize the opportunity of being pushed in this direction to improve the longrun chances for productivity, which clearly is in everybody's interest.

Senator **Domenici**. I am fully aware of the competing claims and the political repercussions of having just that kind of tax change made. I did not suggest that that would be the only one. I have read your suggestions carefully on social security; I have read it on bracket creep. I am merely trying to make the point that all tax cuts would not be inflationary in 1981. They might be other things, but they would not be inflationary, and you are agreeing with that.

Dr. **Rivlin**. I agree that a well-designed plan to stimulate investment in the long run would probably make the economy less inflation prone and would probably be worth the escalation of the deficit in the short run. But nothing is free. It may well be that an increasing deficit and inflationary expectations increase inflation in the short run. It is always a question of trading the long and the short——

Senator **Domenici**. And it might not even have a long-term effect on cumulative deficits.

Dr. **Rivlin**. That is right.

Senator **Domenici**. But, it might have a beneficial effect on that.

Dr. **Rivlin**. That is certainly possible.

Senator **Domenici**. In any of these programs that you suggested as far as notions on taxation, have you and your people figured the reflows anywhere? I did not notice whether they were in the statement or not.

Dr. **Rivlin**. We have worked on that. It is very difficult to estimate exactly what they are, especially on the business taxes where we do not have much experience with these kinds of changes; it is easier on the consumer taxes. But we could provide you what we have done, for the record.

Senator **Domenici**. I wonder if they could provide that for us.

Chairman **Hollings**. Would you, please?

Dr. **Rivlin**. Yes.

Senator **Domenici**. Thank you, Mr. Chairman.

[The following was subsequently supplied for the record:]

Estimating Reflows From Tax Cuts

Reflows are the extra revenues and reductions in federal spending produced by increased economic activity that results from fiscal policy stimulus. The flow of these funds back to the treasury reduces the net cost of fiscal policy. Reflows derived from increases in real activity, of course, are more desirable than those due to higher rates of inflation. However, payments on the national debt rise, offsetting some of the positive tax reflow effects.

In order to estimate reflows it is necessary to measure the total impacts of policy changes on the economy. There is greater agreement among economists about the likely impact of a cut in personal taxes than about business tax cuts. An illustrative personal tax package has recently been examined by CBO on three commercial macroeconomic models. Personal income taxes were reduced by $10 billion over a three year period. The range of estimates of reflows, as a percentage of the original revenue loss, for the three models, averaged between 15 percent and 30 percent for the first three years. The CBO's estimates of reflows are typically at the high end of this range.

The economic impacts of changes in business taxes are less well known. This is due to the divergent opinion among economists as to the responses of the economy to changes in investment incentives. Furthermore, the most important effects of such policies occur after several years, when the precision of large econometric model estimates is quite poor. It is generally thought, however, that more liberalized depreciation benefits would reduce inflation and that the boost to real output and employment would be longer lasting than for a similar-size reduction in personal taxes.

Reflecting these uncertainties, reflow estimates from the three commercial models are wide ranging for an illustrative package of liberalized depreciation benefits. The ADR range was increased to 40 percent and tax lifetimes were reduced for structures, creating a direct revenue loss averaging $3.8 billion in the first three years. The reflow estimates as a percent of the original tax loss, for the three models, ranged from 0 to 100 percent. Such a wide range of estimates clearly highlights the uncertainties that are associated with the determination of an appropriate reflow, particularly for changes in business tax depreciation policies.

Chairman HOLLINGS. Senator Exon.

PROJECTED ANNUAL INFLATION RATE FOR 1981–83

Senator EXON. Dr. Rivlin, we are very pleased to have you here this morning. I would like to turn to the problem of inflation for a little bit.

With your experience in the past and looking into the future, as you economists do, what are your projections as to the minimum inflation rate that we can expect in 1981, 1982, and 1983? What is the annual inflation rate that you would predict that we will look back on in 1984 for those 3 years?

Dr. RIVLIN. As you can see in table 1 in my statement,[1] we are projecting that the GNP deflator, which is the best general measure of inflation, will decline only slowly over the next couple of years; that it will actually be a little worse for the whole of 1980 than it was in 1979, although it will come down slightly in the second half of the year.

Taking the midpoint of the range, we are projecting a rise in 1981 of just under 9 percent. One could expect it to come down gradually, if there are no other shocks, over the next several years from that level.

INFLATION RATE FOR NEXT 3 YEARS TO AVERAGE 8 PERCENT

Senator EXON. To simplify, then, and to get to the heart of my question, would it be fair to assume from your projection that an average of 8 percent a year over the next 3 years would be somewhere in the ballpark?

Dr. RIVLIN. Yes. I think one could hope, by 1982, to get it down around 8 percent, and maybe below.

---

[1] See p. 105.

EXPECTATION OF CONTINUED INFLATION SPURS CONSUMER SPENDING

Senator EXON. That falls right in line with a similar question that I have asked other witnesses, and there seems to be a nearly unanimous feeling among the distinguished economists that we have had here, including yourself, that we are going to have an inflation rate of about 8 percent per year for the next 3 years.

Now, we talk about what we are going to do; we are going to balance the budget, and we are going to do this and we are going to do that. You said earlier in your testimony that consumers went on spending longer than the economists expected, from the projections we were receiving a year ago.

I think the basic reason for that, and maybe the Achilles heel of all of our planning is the fact that we have so permeated our system that the average person in America is recognizing that with an annual inflation rate of 8 percent, he or she had better buy or borrow all the money they can, because if you are going to continue inflation at a rate of 8 percent a year, there is only one way to beat it.

I am not asking for some free advice, but maybe some advice for my people back home. When we are talking about a tax cut, are we not like the drug addict that is pumping himself with a needle to get out of this immediate situation, lacking any real program to be tough?

The administration, for example, in March, as Senator Bellmon pointed out, started out on a program to make it tougher to borrow money, and they made it tougher to borrow money. As soon as we went on that program, we heard cries that we had to get the rate down because it was throwing us into a recession.

I guess what I am saying is that I am fearful that what we do here is sit and make political decisions, because we are political animals, and all we do is claw at the door, so to speak, without any real plan to eliminate inflation.

Certainly, no one can be happy with a projected 8 percent inflation rate for the next 3 years. Where are we going with that kind of an inflation rate? Are we not saying to the people, "Continue with your spending and borrowing habits as in the past, because that is the only way you can keep up?"

Dr. RIVLIN. Your explanation of what was happening at the end of last year and early this year is probably correct. There is a good deal of evidence that part of the reason for the high levels of consumer spending was the anticipation of further inflation. The feeling was, "Buy now rather than later because it will be more expensive."

Senator EXON. Pay off with cheap dollars.

Dr. RIVLIN. Yes, and borrowing is not so expensive in real terms.

What has happened to perceptions in the last few months is hard to say. Consumers have been battered by several things, and apparently expectations have turned around some. There was some nervousness about the high levels of debt that consumers were maintaining. People are now retrenching and not buying things because they are worried about the future.

But you are correct that we are in a bind. Once an inflation starts, it is very difficult to wind down. About the best we can hope for is that it comes down slowly over the next few years. The

Government has to be very careful not to do things that would make it worse again, because once it starts up again, you have the increased problem of renewed inflationary expectations that become self-fulfilling prophecies.

PRECIPITOUS DROP FOR REAL ESTATE PRICES?

Senator **Exon**. Well, my personal pride has been hurt here, because my kids, who are in their twenties and early thirties, if they had listened to their dad, they would not have the investments and borrowed the money that they did over the last 15 years. I told them, "Do not get yourself in debt."

The facts of the matter are that their net worth, because they failed to follow their father's advice, has appreciated much faster than their father's, so my pride has been hurt a little bit. [Laughter.]

Nevertheless, I think we have to be truthful and honest with the people. I guess that the more I see of this and in my experience of a year and a half on this committee and wrestling with these problems, I do not know where we are going.

But where we are going takes me to one last question that I wanted to explore with you. During the recent recess, I had an opportunity to read a book that predicted a precipitous decline in real estate values because of the boom and the rise in prices, and that in the next 2 or 3 years we are going to see the bursting of that bubble and we are going to see a drop in real estate prices of about two-thirds.

I do not know how accurate these estimates and projections are, but I think it reported quite accurately that the net worth of the average person today is tied up basically in their home ownership.

Now, do you believe that there is going to be any precipitous drop in real estate prices, from your vantage point, in the next 2 or 3 years?

DEMOGRAPHIC STRUCTURE OF ECONOMY PRECLUDES LOWER REAL ESTATE PRICES

Dr. **Rivlin**. I am not an expert on real estate but it seems to me unlikely that we will have a precipitous drop. The demographic structure of the economy is such that we now have a large group of young people coming along who are in the age group to buy houses. That will put some upward pressure on the housing market, no matter what. My guess is that we will not have a precipitous decline in real estate values, but that should be taken with a grain of salt.

Senator **Exon**. Thank you, Dr. Rivlin. Thank you, Mr. Chairman.

Chairman **Hollings**. Thank you.

Senator Pressler.

REASONS FOR SHORTFALL IN EXPECTED RECEIPTS

Senator **Pressler**. We were looking at page XVI here of your Economic Outlook,[1] and let me thank you very much for that document.

In the first concurrent resolution, the receipts were $613 billion.

---

[1] See "The Economic Outlook At Midyear 1980," U.S. Government, Congressional Budget Office, Washington, D.C., July 1980.

There is $613 billion in the first concurrent resolution, but CBO's reestimated there, apparently, $600 to $605 billion. Also, down below, the first concurrent resolution on outlays was $613 billion, and then there apparently was a reestimation of $630 billion.

Let us take the first line item first, the receipts. What caused that to come down? From my point of view, of course, I am always interested in agriculture and agricultural support programs. Was that a factor in the change in those?

Senator Bellmon. Larry, which page are you on?

Senator Pressler. I am on page——

Dr. Rivlin. It is page roman numeral 16 in the report, summary table 2, right?

Senator Pressler. Yes; xvi.

Dr. Rivlin. It is also table 2 in the testimony.[1]

Senator Pressler. Could you make some comments on what caused those changes in those two line items?

LOWER EXPECTED RECEIPTS DUE TO PESSIMISTIC OUTLOOK OF ECONOMY

Dr. Rivlin. The main factor in the lower expected receipts is a more pessimistic outlook of the economy. What has happened since March is that we are now forecasting a higher unemployment rate in 1981. The receipts are expected to be down largely for that reason.

On outlays, the change is caused by several different things, and the increase has really been quite dramatic. One reason is the recession itself. The more gloomy economic outlook raises unemployment insurance, trade adjustment assistance, food stamps, and related public assistance programs by about $8 to $10 billion. Most of that is unemployment insurance increases.

There has also been a substantial increase in other spending rates, projected to be about $13 to $16 billion. A large part of that is in defense spending. We are estimating now that defense spending will be $4 to $7 billion above what we thought it would be last spring. This revised estimate is based on later information and what has been going on—for example, the U.S. Navy steaming around the Indian Ocean, the higher rates of petroleum purchased at higher prices for the Armed Forces, and that sort of thing.

Those changes are partly offset, however, by somewhat lower estimates of interest costs, so that not everything is going up. But on balance, there has been a substantial increase in the outlays estimated.

Senator Pressler. Maybe it is in here and I overlooked it, but you did not have any projections in the agricultural sector.

Dr. Rivlin. No, there are no major reestimates at this time for spending for farm price supports or other agricultural programs.

Senator Pressler. Down in the last item, deficit or surplus, it is now projected to be a $25 or $35 billion deficit for 1981.

Dr. Rivlin. Right. That is a combination of the lower receipts largely attributable to the recession, and the higher spending partly, but not entirely, attributable to the recession.

---

[1] See p. 106.

IMPACT OF 10-5-3 TAX PROGRAM ON RECEIPTS

Senator Pressler. On the receipts side, if we enacted a 10-5-3 depreciation program, in the short run that would probably cause the receipts to go down. Although it is argued that in the long run 10-5-3 would increase economic activity and tax receipts. Nobody really knows.

Would it be your estimation that in the short run it would decrease receipts.

Dr. Rivlin. Yes, slightly. A feature of 10-5-3, as currently drafted, is that the revenue losses in the early years are relatively small, because the program would be phased in. But the revenue losses build up rapidly to very large numbers as the program comes into full effect.

Senator Pressler. That is right. I guess that in the first couple of years of 10-5-3, it would not have the effect that it would after about 5 to 6 years.

Dr. Rivlin. Yes, that is right. In fact, those estimates are shown in table 5 of the testimony.[1] We estimate that immediate enactment of 10-5-3, as currently drafted, would cost only about $3 billion in fiscal 1981, but the cost in terms of revenue loss would build up very rapidly to over $40 billion in 1985 and would go higher than that before coming down.

Senator Pressler. So, your feeling is that 10-5-3, in 1985, would mean a $40 billion loss in revenue?

Dr. Rivlin. Yes. The program is expensive and the cost builds up fairly rapidly in the outyears. That is one of the things that would have to be thought about very, very carefully in enacting such a program.

Senator Pressler. Well, thank you very much. Thank you, Mr. Chairman.

PROJECTED UNEMPLOYMENT RATE

Chairman Hollings. Dr. Rivlin, let me get right to these projections, going specifically to some of the figures used by Senator Pressler that are in that chart. In your testimony you stated, "The unemployment rate is projected to continue to rise this year, reaching 8.4 to 9.4 percent by the fourth quarter and continuing within this range throughout 1981."

Now, I can understand your sensitivity of giving us a hedge rather than a figure. We have to vote a figure; we cannot vote like the weather report. Well, we have a 70 percent chance of balancing—I do not know whether that writer is still back there or not, but we were 70 percent correct. And the baseball players feel good when they get a .300 batting average, so I do not think we are too bad.

We still have to deal a little bit more exactly, and when you give us a 1 percent range of difference, that is $25 billion.

Dr. Rivlin. That is right. We give you the range to indicate our level of uncertainty.

Chairman Hollings. We cannot vote a range; we have to vote a figure.

---

[1] See p. 111.

Dr. RIVLIN. I understand that. Also, for purposes of marking up the resolution, we advise you to use the midpoint of our ranges, which in the case of the employment rate is 8.9 percent.

ASSESSMENT OF FEDERAL RESERVE POLICY

Chairman HOLLINGS. Well, good.

Do you think the Federal Reserve used the proper policy with respect to the money supply, credit controls, and everything else of that kind? It is striking strange that all the economists were a full percentage point off in the unemployment figure, which is what our grief is.

We were using not only CBO, but the consensus of 40 forecasters. We ordinarily use just the January figures to mark up the first concurrent resolution. We got a March projection, and yet between March and July, we were a total percent off, which has gotten us in our dilemma now of a $25 to $30 billion deficit for 1981, or, with a tax cut, near $60 billion again.

Do you think that the Federal Reserve used the proper policy of restraint of money supply and credit controls or not?

Dr. RIVLIN. It is hard to define "proper policy." As Chairman Volcker indicated in his statement of yesterday, the Federal Reserve is very concerned about inflation and very concerned about the international exchange value of the dollar. These two concerns are related, and indeed they should be.

There may, however, have been an overreaction. I do not think the Federal Reserve was trying to precipitate a recession of severe magnitude. Everyone had been projecting a recession for some time, and yet it did not seem to be happening. Spending was higher than had been predicted, and the Federal Reserve kept tightening and taking more restrictive action. Finally, things turned down, and turned down in a big way. That is the way business cycles work.

Chairman HOLLINGS. So you have no criticism of the Federal Reserve?

Dr. RIVLIN. I do not think it is my place, Mr. Chairman, to take a position on whether the Federal Reserve is right or wrong.

DISPARITIES IN ECONOMIC PROJECTIONS THREATEN CREDIBILITY OF BUDGET COMMITTEE

Chairman HOLLINGS. Well, we do have to decide whether they are right or wrong because we are the ones who have to run with the ball.

Now, going back to the state of the art on projections and estimates, is there anything that we can do—the Budget Committee's credibility is rather shaken when we are that far off that quickly. I could see it with Mount St. Helen's, and everybody could see the discord in Miami and the various other disasters that we have had; those are understood immediately; they could not be foreseen.

But to leave town and have an $8 billion drop off in revenues and an equivalent $8 billion increase in spending—something is wrong with the projections, when we are $8 billion off on the revenue side.

Dr. **Rivlin**. Clearly, the state of the art in making these projections is very uncertain; I suspect that it always will be. I think it would be a shame if the Congress overreacted or felt that they had done something terrible.

What you have achieved with all of this effort to pass the first resolution is a substantial cutback in the rate of increase of Government spending and a budget that is restraining the economy.

AMEND BUDGET ACT FOR BETTER CONTROL OVER GOVERNMENT SPENDING

Chairman **Hollings**. Well, now, wait a minute; you are saying a cutback. That is my other problem; there is not a cutback in Government spending. That is projected for the 1981 budget, but the 1980 budget is what I am talking about. On the contrary, there has been a dramatic increase of $8 billion.

I am going to ask, is there something that you could recommend from the Congressional Budget Office standpoint to us as a budget committee, such as an amendment to the Budget Act, in order to have a little bit better control over Government spending?

How is it that all of a sudden the Defense Department can, within the last 60 days, spend $4 billion more than what we have expected? Something is wrong with our communications with Defense or with mass transit, or all the rest of the things that are in that $8 billion increase in spending that has been referred to here, whether it is medicare, mass transit, EPA, or price supports.

You just have to put yourself in our position in a conference committee, fussing at 1 in the morning over $100 million, and I mean no give and take; just beat each other up, and then we adjourn, come back and have another news conference, and then fuss again about another $100 million.

In fact, that was what was recommended yesterday. The first economist said we were either naive or incompetent. Another one recommended that we amend the Constitution to make sure we could not do anything unless there was a three-fifths vote, 60 percent.

Finally, one said, "Really, what you ought to do is go home for 6 months a year and give yourselves time and a half pay to make sure you stayed home." [Laughter.]

Well, we went home, and I come back and I have spent $8 billion more, and I am supposed to be chairman of the Budget Committee and know what is going on. Now, something is wrong with this system, if they can out spend me in 2 weeks' time during the convention by $8 billion. [Laughter.]

Senator **Chiles**. And you did not get your time and a half.

Chairman **Hollings**. I did not get my time and a half either; that is right. [Laughter.]

Dr. **Rivlin**. You are quite right. Very little of the increase can be blamed on the Congress in any legitimate way. There was a more rapid rate of spending in a number of programs than had been anticipated. I think you are quite right to feel let down by the process of estimation and perhaps by communication between the Congress and the executive branch.

Chairman **Hollings**. Well, how do we improve that? Is there some way that it can be monitored better by the Congressional

Budget Office or by the committees? I just do not see how we can be that far off in this fiscal year.

Is there something wrong over there at the OMB?

Dr. RIVLIN. We were all surprised by the sudden downturn in the economy during the second quarter. About 60 percent of our spending reestimates for 1980 can be related to the recession. For example, our estimates for unemployment compensation benefits for 1980 are now $2 billion higher than was assumed for the revised second resolution. Another $1.4 billion is for increased outlays by the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation resulting from bank failures because of the recent credit crunch.

In addition, our analysis of the latest Treasury statements and the OMB midsession budget review indicates that the actual spending rates for several programs are somewhat higher than was assumed a few months ago when the revisions to the second resolution were being put together. The largest items in this category are Defense Department spending, medicare and medicaid, and urban mass transportation grants. We estimate that higher spending rates for these and other programs will add about $4 billion to 1980 outlays above the levels assumed for the revised second resolution.

Not all of our reestimates were up. Lower interest rates will result in lower spending in 1980 of over $1 billion from the level previously estimated.

MAJOR FAILING INDUSTRIES

Chairman HOLLINGS. Well, maybe that answers the question.

There is just one thing that is really not in the CBO's field, and that is the sick industries that Senator Chiles has been asking about. The rhetoric sometimes is extreme by us in public office; we just take the least little hint and we can run a touchdown with it.

There is the auto industry and steel; are there any other sick industries that you know of?

Dr. RIVLIN. Those are the major ones, I think.

IMPACT OF SPENDING PROGRAMS ON INFLATION

Chairman HOLLINGS. Someone said maybe the airlines and the railroads, but the railroads have been sick for 30 years; there has been no change there.

The economy is not really that bad off, and there is nothing we can do, other than just additional spending programs, as you indicated, to ameliorate the 9 percent unemployment that is going to persist in fiscal year 1981. There is nothing we could put in that budget, because if we put it in that budget, all that increased spending, then we are going to meet ourselves coming around the corner on inflation all over again. Is that correct; is that the right impression, or have I gotten the wrong impression?

Dr. RIVLIN. I think that is the right impression. If our forecast is correct, the unemployment rate will rise in the second half of this year and there is very little that can be done to prevent that rise that would not risk rapid inflation later. That does not mean that you should not think about how to make the economy less inflation-prone in the future, or whether to enhance the recovery.

I see very little that the Congress could do that would change the economic outlook in the next 6 months.

Chairman HOLLINGS. Do you have any other questions?

IMPACT OF FEDERAL DEBT AND BUDGET DEFICITS ON INFLATION

Senator BELLMON. Yes, I do.

Dr. Rivlin, following along the line of questioning that our Chairman has been pursuing, I hope you sense some of the frustration that some of us feel. I have been on this committee now for 5 years. I came to the Congress 12 years ago after having been Governor, where we were required to have a balanced budget. I felt it was important that the Federal budget be balanced, at least most of the time, because even though some of the economists tell us it does not matter that we have $900 billion in debt, I know that if we did not have that debt, we would have a balanced budget, because the debt service is $70 billion in this current year.

It is important that we try not to keep adding to this debt year after year after year. Even though some say that this imbalance does not affect inflation, I disagree. If we did not have the debt and did not have deficits, I do not believe we would be having inflation now up in the double-digit range.

We have worked for 5 years; we thought we had a 1980 deficit of $27.7 billion when we approved the Second Concurrent Resolution. We found out a while back that it was going to be $47 billion, and now we find it is going to be $63 billion. We thought we had balance in 1981, and now we are told, as the Chairman has said, that it will be at least $30 billion in deficit and maybe as much as $50 or $60 billion if we have a tax cut.

ROLE OF FEDERAL RESERVE IN CURRENT ECONOMIC CRISIS

Not only is there something wrong with the system, but I think we have to do better than this. We are not captives of these situations. I personally think that the Fed did us in. They adopted very restrictive monetary policies, perhaps with good intentions, but they certainly did not want the result we got; at least I do not want it, and I do not believe that Mr. Volcker wanted to see unemployment go to 9 percent and stay there for 2 years.

Now, my question is, what do we do now? We cannot just sit here and wring our hands. Something is going to be done; whether the Budget Committee recommends it or whether it comes out of Mr. Reagan's camp or Mr. Carter's camp, something is going to be done about this before election day.

What are your suggestions?

Dr. RIVLIN. Perhaps that the best policy would be to do nothing—that is, to stand pat. You have worked hard on the fiscal 1981 budget. Although that budget will not be balanced in all probability, it is not obvious that you should move rapidly to correct that. It depends, really, on this very difficult problem of weighing the advantage of increasing the chances that the recovery will be strong against the danger of escalating the inflation.

Senator BELLMON. You said in your statement that inflation is not going to change very much, regardless of what we do.

MASSIVE TAX CUTS COULD ESCALATE INFLATION

Dr. **Rivlin**. I think you could make inflation much worse. When I was talking to Senator Exon, I was agreeing with him that there really is not much you can do to make it a lot better quickly; this will happen only slowly.

But to take an extreme case, a massive individual income tax cut that really escalated the deficit, would likely give you a lot more inflation than you would otherwise have in the next 2 or 3 years. It might not happen immediately, but that is the danger to be weighed.

The best you can hope for with quite restrictive policies is that the inflation comes down slowly over the next few years. But that is the "best." There could be a "worse."

CHANGES IN CBO FORECASTS ON UNEMPLOYMENT

Senator **Bellmon**. Now, the assumptions we got from CBO—and I am one of the ones who felt we ought to follow your recommendations or your conclusions—but the assumptions we used in March were: unemployment, 7.45 percent; the CPI increase for fiscal year 1981 would average 10.6 percent real; growth in GNP would be 0.3 percent; and the Treasury bill rate would be 10 percent.

Now, your July forecasts are that unemployment would go from 7.5 to 9 percent; CPI will come down a little more, down to 9.6 percent. There will be an actual decline in real GNP of 0.7 percent; and the Treasury bill rate will average 8.31 percent.

I cannot see anything that has happened since March that would cause that dramatic change in the unemployment rate. What I see happening would make the prospects for employment more promising, because housing starts have picked up and auto sales have picked up.

I know that in the area where I live, the energy business is running flat out; you cannot even get a drilling rig now unless you stand in line for 6 months, and I know they are building new equipment as fast as they can. There are strong elements in this economy.

What has happened, specifically, that causes CBO to be so much more pessimistic? Now, let me just say one other thing before you answer. If we stayed with your March assumptions, we would almost have a balanced budget again.

Dr. **Rivlin**. That is correct, but those March assumptions they look very unlikely at the moment.

In fact, the turn was already happening in March. But when you are talking in March, you are using January and February data and you do not really know what is going on in March.

Senator **Bellmon**. Does not CBO look ahead a little bit? You do not just make these projections looking backwards, I hope.

CBO JULY ASSUMPTIONS REFLECT DRAMATIC DROP IN ECONOMY

Dr. **Rivlin**. No, but you have to look at what has happened and the likely effects of what has already happened on the rest of the economy. What has happened in the second quarter has been a dramatic drop in almost everything—in sales and in output—and a dramatic rise in unemployment.

Senator **Bellmon**. Unemployment was 7.7 percent in the last report we had last month; that is not so dramatic.

Dr. **Rivlin**. It is up a full point since January.

Senator **Bellmon**. But you forecast 7.5 percent.

Dr. **Rivlin**. And it is already higher than that.

Senator **Bellmon**. By 0.2 percent, which is very little.

Dr. **Rivlin**. What I am saying is that when you get a dramatic drop in the economy as we have had in the last 3 months, the normal thing that happens is that that spills over and is not immediately corrected. Looking at the history of past recessions, that is what you would expect.

Now, we may be wrong, but what is likely to happen when sales drop precipitously, as they did in the last quarter, is that businesses find themselves with more inventory than they really want. So, they do not order anymore; they wait until they work off the inventory. That means that production is not as high as we thought it was going to be.

Then, people get laid off and when people get laid off, they do not spend as much.

RECESSION CREATED BY FEDERAL RESERVE BOARD

Senator **Bellmon**. I am not an economist, for which I give thanks, but in my judgment this is not a typical recession. This is a recession deliberately produced in Washington by the Federal Reserve Board; they wanted a recession and they have it.

People still want houses; they still want cars. The demand is still out there. The reason they are not buying is because interest is so high. Interest has now come down, and if I am any judge of human nature, one of these days people are going to wake up and say, "Well, that house we wanted which we could not afford at 20 percent interest, we can now afford at 12 percent." So, they are going to start buying and people will start building and go back to work.

I just hate to see Congress be panicked into a big tax cut or a big spending program, and produce another enormous deficit by somebody's guesses, when you have been guessing wrong for so long.

Dr. **Rivlin**. I have a great deal of sympathy with that point of view. We have been wrong before. But based on what has happened in the past, and that is all we have to go on, a recession does not get instantly cured once it gets started. I hope you are right, but I do not see any evidence that this is likely.

EVIDENCE CITED OF ECONOMIC UPTURN

Senator **Bellmon**. Well, do you not see evidence that housing is beginning to pick up?

Dr. **Rivlin**. Yes, I think that housing is beginning——

Senator **Bellmon**. Do you not see evidence that auto sales are picking up?

Dr. **Rivlin**. Yes.

Senator **Bellmon**. Well, what more evidence do you want? Those are the two segments of the economy that got sick so quickly.

Dr. **Rivlin**. That is right. I also see the ratio of inventory to sales relatively high. I see the fact that industrial production has been declining quite rapidly and that a lot of people are out of work. What normally follow from that are secondary effects such a decline in business investment reflecting the decline in sales.

Now, it may not happen this time, and I hope you are right, but that is what has happened in the past.

Senator **Bellmon**. Have we ever had another recession that was so precipitously brought on by one thing, which is a decrease in the availability of money?

Dr. **Rivlin**. The contractions from the fourth quarter of 1974 to the first quarter of 1975 was sharper, with the money crunch more severe. The monetary moves this time were quite dramatic. But before we sound as though the recession just happened in March, remember that the economy slowed down a lot last year. It did not drop quite as much as economists expected, but in 1979 there was a dramatic slowdown in the economy.

As a matter of fact, the CBO projection of January 1979 was approximately right. We projected that the economy in 1979 would slow down from about a 5 percent growth rate in 1978 to about a 1 percent growth rate in 1979, and that was what happened.

One thing that did not go along with that, however, was a rise in the unemployment rate; that was delayed. Another thing that did not go along with it was a slow down in consumer spending as normally would have been expected.

So, another way of looking at this recession is that it built up for a long time and then, largely because of the monetary moves, finally happened more rapidly than might otherwise have been.

Senator **Bellmon**. I yield; go ahead.

IMPACT OF DECREASED CONSUMER SPENDING ON INFLATION

Senator **Chiles**. I was just going to say, everybody now is blaming Volcker in a lot of instances for bringing about the recession. I remember, before the Fed made all those moves, that everytime they raised the interest rate, all the bankers and everybody else said that that was not enough; he had not moved strong enough.

We thought Volcker was coming to the Fed and he was going to be a tight money man, and he is not doing it. They kept citing the examples: "Look at what is happening in all of the spending."

All of the polls were showing us, too, that the consumer had decided that inflation was not going to abate, but was going to be worse the next year than it was this year, so they ought to go buy now. I think that was feeding it.

Finally, of course, they kept tightening and tightening, and I was one of the ones clamoring for restricting consumer credit; I think a lot of other people were at the time, and were saying they were late in doing it. Finally, I think it happened to be an accumulation, because the consumer was about ready to stop. But we did not know that and we put all of this on.

Having said that, it is interesting to note that I am seeing some of the consumer confidence indices that show, for the first time, a pretty precipitous drop by 10 percent in the number of consumers who think that inflation will be worse next year. In other words, while 80 percent used to think it was going to be worse next year, the numbers are now 70 percent.

Well, that does not say that a lot of them do not think it is worse, but it is the first time, as I understand it, that that has shown a drop in a long time. So, to that extent, we said our biggest problem was that inflation would be feeding on itself and becoming a self-fulfilling prophecy that had to happen, because as long as the businessman and consumer thought inflation would be worse next year, they would not fail to spend and they would go out there and buy things they did not need.

So, to that extent, is that not a positive sign toward trying to ultimately unravel inflation?

Dr. RIVLIN. Yes, I think so.

In defense of Mr. Volcker, let us remember that in January and February of this year the Consumer Price Index was going up at an 18-percent annual rate and many people, including members of this committee were feeling a little desperate.

POLICY OF FED AIMED AT RESTORING CONFIDENCE IN THE DOLLAR

Senator CHILES. And those interest rates that people now want to blame Volcker for—when you have 18-percent inflation, it is a mighty dumb bank that is going to loan money at 20 percent, really, because they are getting 2 percent on their money if the true rate of inflation is 18 percent.

Regardless of what he was doing on credit, the banks were raising that interest rate tighter than he was, watching that inflation index going up. What, if anything, the Fed was trying to do was to put some confidence in the dollar internationally.

TAX CUT OR SPENDING INCREASES WOULD ADD TO INFLATIONARY SPIRAL

Senator BELLMON. Mr. Chairman, let me keep the record straight. I am not critical of Volcker; I think the Fed did what probably needed to be done. But I think the danger is that the Fed has corrected for changes in the economy, and now here we come, Congress, and we are also going to also correct, so we are going to wind up with a double dose of correction and get inflation kicked off again.

I think we are mistaken if we think this situation is as dismal as it has been painted here over the last couple of days, and that we are going to make a serious blunder if we come along now with a big tax cut or with a big increase in spending, because I think this situation will straighten itself out——

Senator CHILES. I agree with you.

Senator BELLMON [continuing]. Assuming the Fed's monetary policy has made proper adjustments.

SIZE OF TAX CUT NECESSARY TO REDUCE UNEMPLOYMENT BY END OF YEAR

Senator CHILES. I tend to agree with you there.

Alice, I wonder, for the record, if you would—or maybe you can tell us now—how much of a 1980 tax cut would be necessary to bring the unemployment rate at the end of the year down to the level that we projected with the balanced budget for the first resolution?

Dr. RIVLIN. A 1981 tax cut that would bring the unemployment rate down to 7.5 percent?

Senator CHILES. Right.

Dr. RIVLIN. We can think about that, but it is a very difficult question to answer. It is not clear that any reasonable size tax cut would bring the unemployment rate down that fast, if you assume that our forecast is correct.

Senator CHILES. Well, if it is true that it will not bring it down, I think that would be important for us to know, because we are told that one of the reasons to have this tax cut is to keep this terrible unemployment rate from being on people's backs. If a tax cut is not going to give us that but is going to give us inflation, I think we need to know that.

NO SHORT-RUN CURE FOR RISING UNEMPLOYMENT

Dr. RIVLIN. If our forecast is correct, there is nothing the Congress can do with respect to fiscal policy to prevent the unemployment rate from rising over the next few months. If you then start in January 1981 and say, "OK, it happened; we have an 8.9 percent unemployment rate. What can we do this year to get it back to 7.4 or 7.5 percent?" That is probably a larger order than the tax system could handle efficiently.

A huge tax cut of the sort that would be necessary to bring the unemployment rate down that rapidly would be very inflationary in the longer run. The problem is that once the unemployment rate rises, it is very sticky on the way down. You can stimulate the economy a lot and get production up a lot without bringing the unemployment rate down very much. We had that problem in 1975–76.

So, the answer may be that there is probably nothing feasible you could do with fiscal policy that would meet those conditions.

Senator CHILES. Thank you.

INFLATION CAUSED BY GOVERNMENT DEFICITS

Chairman HOLLINGS. Dr. Rivlin, do you believe that government deficits cause inflation?

Dr. RIVLIN. Sometimes. They are not the only cause of inflation, but certainly when the economy is running at near full capacity, a deficit can be very inflationary.

Chairman HOLLINGS. With respect to getting a better handle on the Government's spending, we come back and we have spent $8 billion more. There was an interesting article in the Outlook section of the Washington Post, I think, two Sundays ago by a gentleman by the name of Choate, talking about the cost of delay, and it was very impressive.

I want to send you that article—but the cost of delay went along with the reference in that article to $100 billion in the pipeline in public works plans, programs and spending that could be expended. An article by John Herbert in the New York Times on June 30 talks of $100 billion already appropriated. That is not only Federal, but State and local, but let us see how much of it is Federal.

In other words, I am going to send you those two articles and ask if that is accurate, and if so, what can we do about it. Are you familiar with that?

Dr. RIVLIN. No, I am not. I would be happy to take a look at the articles.

[The following was subsequently submitted for the record:]

The two articles discuss the findings of a monograph written by Pat Choate entitled "As Time Goes By: The Costs and Consequences of Delay." Mr. Choate, a federal Fellow at the Academy for Contemporary Problems, estimates that public works programs at the federal, state, and local levels have an upset balance of more than $100 billion in funds obligated for specific projects. He further maintains that this backlog is growing in relation to annual disbursals for the same programs, and that the growing backlog is a sign of increasing and unnecessary delay in the planning and construction cycle of public sector capital investment. He attributes a large share of this increase in delay over the last decade to the effects of administrative delay—the simple mismanagement of time by federal, state and local managers.

Mr. Choate derives his estimate of a public works backlog by calculating an average spending pattern for several federally financed public works programs (the Department of Housing and Urban Development's Community Development Block Grant Program (CDBG), Economic Development Administration programs, and the 1976–77 Local Public Works program). Using this average spending pattern and actual public sector capital spending for a given period, Choate extrapolates an estimate of obligated balances by assuming that all previously appropriated funds were being spent at this average spending rate and resulted in outlays for the estimating period equal to actual spending for the same periods. According to Mr. Choate, $60–$70 billion of the $100 billion may represent the federal share of these balances.

Readily available information allows only a preliminary judgment as to the validity of Mr. Choate's analysis. The President's 1981 budget includes data on the unspent obligated and unobligated balances of federal programs at the beginning of fiscal year 1980. A review of the budget indicates that programs with large capital construction components carried a total of over $55 billion in obligated balances and almost $24 billion in unobligated balances into fiscal year 1980. Five of these programs account for approximately 72 percent of the $55 billion in obligated balances, as shown in the following table.

UNSPENT BALANCES IN FEDERAL PROGRAMS WITH MAJOR PUBLIC WORKS COMPONENTS, AS OF SEPT. 30, 1979

[In billions of dollars]

Program	Obligated balances	Unobligated balances	1979 outlays
Federal-Aid highways	13.0	5.0	6.9
EPA construction grants	11.8	4.0	3.8
Urban Mass Transportation Administration	6.0	4.9	2.5
Community development block grants	6.4	0.2	3.2
Tennessee Valley Authority	2.6	3.6	1.9
Subtotal	39.8	17.7	18.3
Other programs	15.8	6.1	NA
Total	55.6	23.8	NA

NA = Not available.

Each of the programs cited above operates in a unique legal, administrative, and political environment that influences the spending rate in various ways and that lends different interpretations to the amount of unspent obligations in each program. The programs differ as to their funding mechanisms, the extent to which appropriations reflect full project costs, the degree of control maintained by the agency over obligation cycles, and the potential for deobligating or reapportioning funds that remain unused after a period of time. Some of the key characteristics of these major capital programs are summarized below.

FEDERAL-AID HIGHWAYS

Approximately 40 percent of the annual budget authority for federal-aid highways is for completion of the interstate highway system. The remaining 60 percent funds a variety of programs, including primary, secondary, and urban road development; the repair, rehabilitation and reconstruction of bridges; and other roads and safety-related construction. Federal funds are apportioned by formula to states prior to the beginning of each fiscal year. States have a total of three years to obligate interstate funds and four years to obligate the non-interstate funds before they are reapportioned. However, there are no time limits for the expenditure of obligated funds.

In order to exercise control over outlays, the Congress has established an overall program obligation ceiling for each fiscal year. For fiscal year 1979, approximately $13 billion was available for obligation to the states, of which $5 billion was unobligated from prior years and $8 billion was available as new contract authority. The Congress set the 1979 obligation ceiling at $8.5 billion, which was easily reached by the end of the year. Some industry groups felt that without the ceiling constraint, states could have obligated nearly $11 billion. The fiscal year 1980 obligation ceiling is $7.6 billion, out of a total of $13.6 billion in available funds ($8.6 billion in new authority and $5 billion in carryover from previous years). Based on obligations to date, it is expected that this ceiling will also be reached.

In general, approximately 7 to 10 percent of each year's funds are expended in the first year, and approximately 30 percent in each of the second and third years. These rates differ by type of project, however.

ENVIRONMENTAL PROTECTION AGENCY (EPA) CONSTRUCTION GRANTS

This program provides grants to municipalities for the construction of wastewater treatment facilities, with localities required to cover 25 percent of the cost and the federal grants covering 75 percent. Appropriations for this purpose were $4.2 billion in fiscal year 1979 and $3.4 billion in 1980. Each year's appropriation is allotted by formula to states and territories, which have two years to obligate the funds before they are reallotted to other states. Substantial funding for this program began in 1973, and after a number of years of relatively slow spending, activity has picked up in the last two years, with outlays totalling almost $3.8 billion in fiscal year 1979, and expected to be over $4.5 billion in 1980. However, there were still $5.9 billion in unobligated funds at the end of May, 1980.

Spending activity in the program is very dependent on state and local actions. Allotments for a number of states are obligated very quickly after the funds become available, but many states obligate large amounts of funds at the very end of the two-year period. (Over 40 percent of the obligations in fiscal years 1978 and 1979 occurred in the last month of each year.) Once funds are obligated, there is no limitation on how quickly they may be spent. Projects often take five to seven years to complete, and no more than 5 percent of each year's obligations are spent within that year.

URBAN MASS TRANSPORTATION ADMINISTRATION (UMTA)

Appropriations for urban mass transportation fund operating assistance, bus purchases, new heavy rail construction, existing rail system modification and extension, research and development in the transit area, and grants to small urban and rural areas to meet transit needs. Of the total transit funding, approximately 30 percent is allocated by statutory formula to urban areas for operating assistance, 45 percent is distributed at the Secretary's discretion for capital projects, and 20 percent is distributed for capital projects through the interstate transfer grant program. Funds are generally available for obligation for four years after appropriation. Once funds are obligated, however, there is no statutory requirement governing the rate of spending of the obligated amounts.

In fiscal year 1979, $3.2 billion of the $3.5 billion in new budget authority was obligated; however, there still remained $4.9 billion in unobligated balances at the end of the fiscal year. Of this amount $4.2 billion is unobligated contract authority, approximately 70 percent of which is from the interstate transfer grant program.

The rate of cash disbursement depends greatly on the type of project. Ninety percent of each year's operating assistance appropriation is expended in the first year and the remainder in the second year. Capital projects take much longer, with the majority of capital funds spent by the end of the fourth year after being made available.

COMMUNITY DEVELOPMENT BLOCK GRANTS (CDBG)

Eighty percent of the CDBG program's annual appropriation is allocated by formula to large cities and counties; the remaining 20 percent is distributed on a competitive basis to small, nonmetropolitan governments. The program finances a range of community development activities, from social services to housing, streets, and larger-scale construction projects.

While there is no legal deadline for obligating funds, HUD's administrative regulations give the agency 75 days to review grant applications. HUD receives most applications between January and June, and most funds are obligated in the year appropriated. (Unobligated balances were only $0.2 billion at the end of fiscal year 1977, $0.8 billion at the end of 1978, and $0.2 billion at the end of 1979, out of annual appropriations of between $3 billion and $4 billion.) Obligations in each year do not necessarily cover the full cost of multiyear projects. Less than 5 percent of each year's appropriation is expended in the first year, as communities complete and submit their applications, HUD reviews them, and contracting arrangements are made. However, about one-third of each year's appropriation is disbursed by the end of the second year, and most of the rest by the third year following appropriation.

TENNESSEE VALLEY AUTHORITY (TVA)

This agency carries out both power and regional development activities, but most of the capital investment is for power generating facilities, and is financed through borrowing and retained earnings. Unlike the other public works programs discussed above, TVA capital spending is in the form of direct investment, rather than grants to states or localities. This program does not receive appropriations, but has the authority to borrow (through the Federal Financing Bank and from the public) up to a specifically legislated amount. Increases in borrowing authority create new budget authority, and this ceiling is raised every several years as the need for funds arises. Since TVA obligates funds as work progresses, its unobligated balances are high soon after ceiling increases are legislated, and decrease until a new increment is provided. (For example, $15 billion in new borrowing authority was provided in 1980, which will result in substantial unobligated balances for the next few years.) TVA's current average project life is ten years, but obligations in each year do not represent the full cost of projects initiated. Most of the funds obligated are spent within two years of obligation.

Unfortunately, the budget accounts do not indicate which portion of the unspent funds are obligated for construction work and which are intended for such other activities as planning and engineering, land acquisition, equipment procurement, and other nonconstruction activities. For example, less than half of the CDBG programs' annual appropriation supports capital construction projects. To the extent that these programs' funds are obligated for activities unrelated to the construction process, the balance recorded for them overstates the construction backlog. On the other hand, backlog estimates derived from the budget data may be understated, since the information excludes unfunded but implied commitments of programs that do not fully fund projects to completion as part of the intitial appropriation or obligation (for example, Corps of Engineers projects).

The existence of large unexpended balances makes accurate budget projections difficult, especially, since four of the five programs with the largest balances involve grants to state or local governments. As a result, the rates of obligation and expenditure are largely determined at the state or local level. A number of different factors account for the existence of these balances, including the following:

States and communities differ in their willingness and ability to make use of federal grants. The allocation of grant funds by formula allots money both to areas that can use it quickly and to areas that cannot.

Programs often lag in the rate of obligation and spending in their early years, as federal agencies develop their administrative mechanisms and states and communities develop management capabilities, plans, and priorities. While spending rates usually increase with time, it may take a number of years to spend the initial backlog.

Construction of some types of projects, even without significant delays, may take two or more years. The process of advertising, reviewing, and awarding construction contracts is also time-consuming. In addition, states and localities often encounter delays in generating their share of construction funds or in resolving legal, jurisdictional, political, social, or environmental concerns that often affect the planning of major public works projects.

Programs in which obligations cover the full cost of projects will inevitably have higher obligated balances than programs in which obligations are made incrementally. Programs for which spending authority is provided in large amounts every few years, rather than in smaller amounts annually, will have relatively high unobligated balances at the beginning of the funding cycle and lower balances at the end (for example, the TVA power program).

From a budgetary standpoint, the key question is the extent of federal control over the spending of these balances. Can the federal government control the rate of spending of these funds so as to prevent large unanticipated bursts of spending? On the other hand, can the federal government speed up spending if it wishes, either on a long-term basis, to minimize the cost of delay, or on a short-term basis, to provide a countercyclical effect during economic downturns? While more detailed study would be required to answer these questions definitively, some preliminary conclusions can be drawn. The four programs with the largest unexpended balances are grants to state or local governments. Activity in these programs appear to be determined primarily by the states and localities, with no clear indication that the programs are poorly managed at the federal level. In the long term, the federal government can constrain the spending of prior balances through obligation limitations (as is now done for federal-aid highways), but short-term variations in outlay rates may still occur. Obligations could perhaps be speeded up by changing matching grant requirements or by more flexible program requirements, but most of the backlog in these programs appears to be attributable to state and local factors. Even a speed-up in the obligation rate will not lead quickly to higher outlays, because of the normal time lag between the obligation and expenditure of funds.

Any attempt to accelerate or more precisely control federally financed public works activities to reduce or stablize backlogs, or to accelerate the delivery of capital investment funds into the economy, would require a more detailed understanding of the reasons for the existence of unexpended balances than is currently available. Mr. Choate's study raises questions about trends in public sector investment that could be studied and, if serious problems are discovered, addresssed by the Congress.

Chairman HOLLINGS. It just seems to me that we have all kinds of programs there waiting, and everything else of that kind, and there ought to be some way of scheduling it, not just waiting for an election or the end of a fiscal year.

We appreciate very much your—excuse me, Senator Exon.

EFFECT OF OFF-BUDGET ITEMS ON INFLATION

Senator EXON. Before we close, Dr. Rivlin, I would like to ask you how we might improve our course of action in the future. I am wondering how much of an effect you feel the inflationary spiral is hurt by off-budget items as opposed to on-budget items. Specifically, I am referring to the Government guaranteed loan programs and some of the housing programs.

There has been some testimony here that would indicate that while we tend to concentrate on the budget items that we deal with directly here, the inflationary spiral, in effect, might be just as serious or more serious for the things over which we have no control as a budget committee.

First, do you agree with that general thesis, and if so, how do we correct it?

BUDGET COMMITTEE SHOULD EXAMINE ALL FEDERAL ACTIVITIES AT ONCE

Dr. RIVLIN. I think you are in the process of correcting it. Yes, I do agree that the budget committees should look at all Federal activities at once. There is some off-budget spending—in the amount of around $18 billion—that is not included in the budget. I think it would be sensible to put that back in the budget so that you can look at the whole thing at once.

CBO has strongly advocated a credit budget. We would urge the Congress to look at all the credit activities of the Federal Government, including guaranteed loans, at the same time that you look at the direct spending. That does not mean that all items would get lumped together as though they were exactly the same thing; they are not exactly the same thing. They might be different tables on the same page. But there is about $142 billion worth of Federal credit activities. That is very substantial.

As you know, this year the administration submitted a credit budget. I would urge the budget committees to focus not only on the regular unified budget but also on the credit budget, because I fully agree with what you are saying.

INFLATIONARY EFFECT OF LOAN GUARANTEES

Senator EXON. I would just like to pursue this a little bit further. Other than spending, per se, which we have a tendency, of course, to concentrate and focus on, when we talk about interest rates and demand for credit and the availability of credit—when the Government says, for example, "Go out and build so many individual homes or apartment buildings," and so forth, although there is no out-of-pocket expenditure as far as the taxpayers are concerned, the more Government activity we have on loan guarantees through our various agencies, the more we are driving, it seems to me—or having the Government encouraging more and more people to come into this field and more and more people competing for the dollars that we have in our economy, which has, I think, a very inflationary effect, at least as far as interest rates are concerned. Do you agree?

Dr. RIVLIN. Increased Federal lending certainly is like increased Federal spending. Loan guarantees, I think, mainly serve to channel credit from one activity to another. They channel more credit into housing or into student loans or into whatever other purpose the Government considers worthy, and less into something else.

BUSINESSMEN IN COMPETITION WITH GOVERNMENT-INSPIRED BORROWING

Senator EXON. But assuming there is enough money—I am talking about a businessman who goes to the money market to borrow money on notes or debentures to raise capital to carry inventories and carry on his business. If he is in competition not only with the Government, which is in there with Treasury bills, but also the Government who guarantees or encourages other people to get into that market, is not that businessman in competition, then, with Government-inspired borrowing, whether it is direct or indirect?

Dr. RIVLIN. Sure.

Senator EXON. Thank you, Mr. Chairman.

Chairman HOLLINGS. Thank you very, very much, Dr. Rivlin, for your presentation today; we appreciate it.

Dr. RIVLIN. Thank you, Mr. Chairman.

[Whereupon, at 12:08 p.m., the committee was adjourned, to reconvene at 2 p.m. on the same day.]

MID-YEAR REVIEW OF FISCAL YEAR 1981 BUDGET

WEDNESDAY, JULY 23, 1980

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 2:05 p.m., in room 6202, Dirksen Senate Office Building, Hon. Ernest F. Hollings, (chairman of the committee) presiding.

Present: Senators Hollings, Chiles, Exon, Bellmon, Domenici, and Kassebaum.

Staff present: John T. McEvoy, staff director; Susan J. Lepper, chief economist.

For the minority, Robert S. Boyd, staff director; Gail D. Shelp, senior economist.

OPENING STATEMENT OF CHAIRMAN HOLLINGS

Chairman Hollings. If we can have a little order, please.

The Budget Committee welcomes the Director of the Office of Management and Budget, Mr. McIntyre, and the Chairman of the Council of Economic Advisers, Mr. Schultze.

We regret that Secretary Miller could not appear with you. We understand he felt compelled to testify at the Finance Committee today on the tax cut issue.

We assume, of course, that you speak jointly for a unified administration position on budget policy. We also appreciate the presence here with you of Treasury officials, including Assistant Secretary Hessler, to assist in answering questions.

Apart from matters of spending detail, we are dismayed that a deteriorating economy has pulled the rug out from under plans of the administration and the Congress for a balanced budget. We would like the best explanation you can give us of where these plans went wrong and of the uncertainties in the current estimates.

We look forward to hearing from you regarding budget policies that best suit the needs of the country and the economy.

Following remarks by other members, we would appreciate such brief summary statements as you may wish to make so that we can proceed as quickly as possible to questions.

The reason that I am trying to move along is that while everyone around the town is talking about cutting taxes, the U.S. Senate, on the floor, at this moment, is increasing taxes $4.2 billion. "Ain't it wonderful?"

We have as part of our reconciliation instructions, cut back spending $6.4 billion, and the Finance Committee was asked to report back a tightening in tax collections to the tune of about $4.2 billion, so Senator Long has that reconciliation bill on the floor here right this minute, but I want to use every minute I can to listen to you.

Senator Bellmon.

OPENING STATEMENT OF SENATOR BELLMON

Senator **Bellmon**. Mr. Chairman, I have a brief statement. I would just like to welcome our witnesses. We always look forward to hearing the views of Dr. Schultze and Mr. McIntyre, and particularly in this situation, their opinions are extremely important to the work of the committee.

CONGRESS BESET WITH PROPOSALS FOR ECONOMIC STIMULUS

Because of the onset of a recession, Congress is currently beset with diverse proposals for economic stimulus designed to increase economic growth, and in particular, the rate of capital investment. Leadership in economic policy during times of stress is particularly important, and we look to the administration for such leadership.

If my reading of the Mid-Session Review[1] is correct, the administration comes before us today with a recommendation for no policy change from the budget it advocated in March. However, circumstances have changed. Most importantly, the budget, which was in balance in March, is now approximately $30 billion in deficit.

ADMINISTRATION'S "NO POLICY CHANGE" POSITION UNSATISFACTORY

I commend the administration for not immediately jumping on the tax cut bandwagon, but a "no policy change" position means acceptance of a $30 billion deficit and I do not believe this is a satisfactory response to the present situation. I don't think Congress will stand pat for the "no change" proposition. Either this committee will continue the policy of budget restraint that it set out last year and thereby cut the deficit; or it will recommend stimulus—probably in the form of a tax cut. I hope that our witnesses today will be very clear as to which of these courses of action they advocate.

In my view, we face an economic future which is by no means certain. Economists who have appeared before this committee during the past 2 days seem to agree unanimously that the current decline will continue to yearend, with only weak economic recovery in 1981 and that the unemployment rate will rise to 9 percent. In fact, the administration's economic forecast shows a weaker recovery in 1981 than almost any other economic forecast. I simply cannot accept such dismal projections.

ECONOMY MAY PROVE STRONGER AND UNEMPLOYMENT LOWER THAN PROJECTED

My own instincts tell me that the recovery will arrive quickly and vigorously and that any further increases in unemployment will be modest. In fact, I am concerned that we will face rising inflation and rising interest rates before the end of this year. If economic policy is stimulative now, we will only hasten the rise in inflation and interest rates, and shorten the recovery.

---

[1] See p. 263.

I hope that, in the course of their testimony this afternoon our witnesses will assess the possibility that the economy may prove stronger, and unemployment lower than they now project. I also look forward to their analysis of economic policy in this environment. I, for one, do not want to repeat the mistakes of the past that have lead Congress to stimulate as the economy recovers and to restrain as the economy weakens. We must come up with an economic policy formula which is more conducive to economic stability.

I welcome you all today, and I look forward to your testimony.

Chairman HOLLINGS. Lawton.

Senator CHILES. No.

Chairman HOLLINGS. Very good.

Mr. Schultze, I will be glad to hear from you, sir.

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you, Mr. Chairman, Senators. I will try to go through my statement, excerpting and summarizing, and try to cut it down, to conserve your time.

Chairman HOLLINGS. The statement in its entirety will be included in the record.[1] You highlight it as you wish.

LEGACIES OF THE PAST DECADE

Mr. SCHULTZE. Thank you, Mr. Chairman.

I will start by noting very briefly that the basic economic problem confronting the country and the problem to which budgetary policy will have to be addressed in 1980 is to restore the growth in output and employment in this economy, while dealing with the three main legacies that the seventies left us with.

One of those three legacies is: First, inflation. Inflation averaged 7.5 percent during the seventies, and it closed the decade here and around the world in double digits.

Second, energy and oil prices. In the eighties, we have to adjust our economy to a world of higher oil prices, and reduce our vulnerability to price and supply decisions abroad.

Third, productivity. In fact, in 1979 productivity actually declined.

So, Mr. Chairman, as we begin to consider economic policies for the eighties, it is important to remember that what we are aiming for, what we need to do, is not merely to increase sales and output in our economy, but to do so in ways that are consistent with dealing with those three big problems: Inflation, energy, productivity.

Let me start with just a very brief look at what has been going on in the past 4 to 5 months, where we have come, and where we are going, as a background for the budget itself.

---

[1] See p. 153.

THE RECENT PAST

During the past year, the immediate objective of economic policy in the United States, and in every major industrial country, has been the same. To quarantine, to isolate, to contain the massive oil-led inflation stemming from a 125 percent increase in world oil prices, and to try to make sure that it does not slop over into the rest of the economy, giving us not just a temporary price bulge, but a double-digit wage-price spiral.

During most of 1979 that objective was met. Prices did rise, consumer prices, by some 13 percent in 1979, but most of that increase in inflation from earlier periods was due to energy and to the associated rise in interest rates, and particularly mortgage interest rates, whose impact on the Consumer Price Index is substantially exaggerated, as this committee has discussed before.

Outside of those two areas, prices were rising at about 7.5 percent during 1979; not much more than during the prior year. That objective of containing the oil price inflation was fairly well met. But by the end of 1979, and into the early months of 1980, that critical economic objective was being threatened. Inflation surged to 18 to 20 percent rates, while some of that was further increases in oil prices—rates of inflation were beginning to accelerate outside of oil.

Wage increases, which remained relatively moderate in 1979, were beginning, in early 1980, to accelerate also. Price expectations about future inflation, we do not have any statistic measurement, but it was clear from casual observations that prices were getting worse. The bond market practically collapsed.

Under these circumstances, the President, the Congress, the Federal Reserve, all together, took some vigorous actions to deal with the situation: Actions with respect to budget reductions, actions with respect to selective credit control. The Federal Reserve, moving on its own, under traditional authority moved to restrain the growth of credit and money.

These actions, Mr. Chairman, had a major effect—It even quicker than anyone anticipated.

Since the time in March when those actions were taken, inflation has significantly slowed. The rate of inflation moved down from its 18- to 20-percent rate to something like 10 to 11 percent.

This morning we got the June Consumer Price Index, which rose at an annual rate of 12.4 percent. Actually, that June Consumer Price Index is an artifact. The main reason for that big increase was the fact that we were picking up in the consumer price increase, mortgage rate increases. That actually occurred in April. There was a long lag between when this actually happens and the time they get in the Consumer Price Index.

PACE OF INFLATION SLOWED SIGNIFICANTLY

Outside of that mortgage financing line in the Consumer Price Index, consumer prices rose at an annual rate of 7.3 percent. Indeed, in the last 3 months, the rate of increase in consumer prices outside of energy and mortgage interest rates has been something about 7.5 percent, far below what was going on in the first 3 months of this year.

In the months immediately ahead, in July and August, and perhaps in September, we will see further reductions in the Consumer Price Index, as decreasing mortgage interest rates take effect.

But the underlying or core rate of inflation, the rate that we more or less have to work down over time is still going to be left at something like 9, 9.5, perhaps 10 percent, somewhere in that range.

In short, however, Mr. Chairman, inflation has slowed significantly, and promises to slow further. Interest rates have come down precipitously. Short term market interest rates are less than half of what they were at the peak. Long rates have followed fairly substantially, and expectations about future inflation, while they are still high, have substantially calmed down.

ECONOMY ENTERING STEEP RECESSION

While there has been a major improvement over the past 3 months in inflation and interest rates, our economy has also entered into a fairly steep recession. The unemployment rate went from 6 percent to 7.5 percent, in May and June. From February to June, employment fell by 1.4 million people. There were large declines in auto and housing starts, and in the second quarter, the Gross National Product fell by 9.1 percent at an annual rate. Ninety percent of that drop in the Gross National Product was concentrated in autos and in housing.

By the end of the second quarter, in June, the recession was changing its character. Autos and housing had bottomed out. The recession was spreading at a more moderate rate to other parts of the economy, as businessmen began to run down their inventories, to move them down in line with the declining sales.

DECLINE IN ECONOMY MODERATING

Evidence has begun to accumulate, Mr. Chairman, that the worst—let me say it another way. The evidence has begun to accumulate that the rate of decline in the economy is moderating. Indeed, some harbingers of the later upturn have begun to appear. Auto sales have bottomed out, and in the first 10 days of July, if you want to believe just 10 days' numbers, there was an upturn.

Real personal consumption expenditures for goods, outside of automobiles, rose in June by slightly under 1 percent. Not much, but the first rise in sometime.

Housing starts jumped by a striking 30 percent in June. Seasonally adjusted, the initial claims for unemployment insurance, which are some rough indication of what is happening to layoffs, fell sharply in the first 2 weeks of July, compared to the June level, and while it is 2 weeks' gain and two robins do not make a spring, in a sense, it is hopeful.

The evidence is beginning to accumulate, as I say, that the rate of inflation is moderating, and a turnaround will be coming later. It is a fair question to ask, Mr. Chairman, since we are all engaged in it, to what extent the recession was brought on by the antiinflationary actions taken last March; to what extent those actions were necessary. It is probably true that failure to have acted last March might have postponed a decline in economy.

It may be that the recession could have been avoided for a time by the continuation of credit extensions at a very rapid pace, but to have avoided acting in the face of rising inflation and accelerated inflationary expectations would have led to a longer period of high interest rates and would have threatened another rise in the hard-to-eliminate underlying rate of inflation.

So, in the long term it would have produced a much worse fall in employment and output.

SHORT-TERM OUTLOOK FOR THE ECONOMY

Let me turn to the short term outlook for our economy, on which the budget is based. There are two major factors underlying the recession, more or less causing the recession, and they are in the process of being reversed, and I have spoken about both of them.

REAL PURCHASING POWER ERODED

During 1979, and particularly in early 1980, the rate of inflation was running significantly ahead of wage increases. Real purchasing power was being substantially eroded. Indeed, that is the way in which the big oil price increase exerted its recessionary influence.

INTEREST RATES DECLINE

As inflation slowed, that erosion of purchasing power will be sharply moderated, ultimately eliminated. Similarly, the sharp decline in interest rates will wipe out one of the major causes of the recession, not only with respect to housing where we have already seen the impact, but throughout the economy, where the high interest rates earlier were having significant effect on economic activity.

BUSINESS INVENTORY LOW

A third favorable factor is the fact that this recession, compared to 1974 and 1975, we did not enter into with a great big speculative inventory boom. Businessmen throughout the economic recovery of the last 3 or 4 years, and even up to very recently, have been very prompt to move production in line with sales, and so when sales level off, we do not have a big overhang of excessive inventories to be worked off. We have some.

There will be a period of working off inventory that will keep the economy going down for a while, but it will not be large. It gives us a much more favorable situation than we had 5 or 6 years ago.

There are two major unanswered questions which affect the economic outlook. The first of these has to do with the consumer.

DETERMINING THE LENGTH AND DEPTH OF THE RECESSION

Early this year the consumer apparently was buying ahead to beat inflation. First. Will the consumer go back to normal behavior, or seeing layoffs among his neighbors and community, will the consumer run to the storm cellar and stop buying? We do not have the answer to that question, but the behavior of retail sales, particularly in June, suggest a favorable answer with respect to the economic outlook, namely, that the consumer, while no longer—

and this is a healthy reaction—running ahead to beat inflation, also is not running to the storm cellar.

Second. The major question to which we do not have an answer is, will businessmen sharply cutback their plans for investment. In every recession, businessmen do that. Businessmen cut back investments. In some cases just by a small amount, but in the post-World War period, by a large one.

Again, they are going to cut back their investment plans in this recession. The question is how much. We do not have an answer to this, but the preliminary evidence on the basis of the surveys of investment plans today is favorable, and while we will get some cut back in investment plans, it is likely to be moderate.

This was the most widely advertised recession in history. In fact, it was advertised for so long before it came that people would not believe it. As a consequence, most businessmen's plans made in late 1979 and early 1980 were made in the anticipation that there would be some recession, and hence the actual recession should not be a traumatic event to cause them to change their plans sharply.

This is not answered, but we believe the evidence is enough to warrant expecting a moderate recession, and the turnaround.

On balance, we believe the pace of the recession is slowing, that the trough of the recession will be reached before the end of the year; 1981 should see a rather slow recovery.

Since the large rundowns in inventories which often accompany a recession do not appear in prospect for this one, the subsequent boost to recovery occasioned by a sharp recovery buildup will also be absent.

ADMINISTRATION'S FORECAST

Table 1 in my testimony,[1] summarizes the major elements of our economic forecast. We are projecting, for over the four quarters of 1980, that the gross national product will fall by 3.1 percent, but that in 1981 it will turn around and rise by a moderate 2.6 percent.

On the basis of this behavior, we estimate that the rate of unemployment will rise to 8.5 percent by the end of 1980, will increase just a shade more in early 1981, and will end up the year 1981 also at 8.5 percent.

Consumer price inflation we project at 12 percent over the year 1980 and 9.75 percent in 1981.

Director McIntyre will lay out the budgetary consequences of this set of economic assumptions.

Mr. Chairman, Senator, the economic forecast I have presented foresees an end to recession before the end of this year followed by, as I indicated earlier, a slow recovery. The administration considers that outlook is not satisfactory.

DEVELOP LONGRUN ECONOMIC RECOVERY PROGRAM

While recovery will occur, it will proceed at a pace insufficient to reduce unemployment significantly. Although inflation will slow down, it is still going to remain too high.

---

[1] See p. 156.

The President, and his administration, therefore, will work with the Congress to develop a longrun program aimed at improving the prospects for noninflationary and sustained recovery.

In designing programs to assist economic recovery, however, we believe that it is absolutely vital that we do so in ways which attack fundamental structural problems and do not merely inject a traditional antirecession stimulus into the economy.

PERCENT CHANGE IN TOTAL EMPLOYMENT

I would like to drive that point home, if I could, by calling your attention to the tables in my testimony. Table 2[1] compares the increase in employment in the United States over the past 3 years, and over the whole decade of the seventies, with the increase in employment in other major countries, in the large countries of the world.

You will note, for example, in the last 3 years, that no other country remotely approaches us in terms of the percentage increase in jobs provided. You will also note that over the whole decade of the seventies, before this recession started, the same thing is true, perhaps even more dramatically.

GROWTH OF INDUSTRIAL PRODUCTION

I do not have a table of manufacturing employment here, but if you had it in front of you, you would see that in manufacturing, it is even more striking. Virtually every other major country in the world has had decreases in manufacturing. In the United States we have had a large increase.

Now, part of the reason for our good employment performance is our poor productivity performance. The rate of productivity growth has been sluggish, but that is not the main reason.

As you will see, if you now look at table 3,[2] over the past 3 years, and over the decade of the seventies, there is only one major country in the world outpacing the United States in terms of industrial production, and that is Japan.

Our industrial production growth was larger than Germany, larger than France, larger than Great Britain, larger than the "Big 4" European countries taken together. What is the point of this?

SHORTRUN ECONOMIC STIMULUS INADEQUATE

The main point is the implications for policy: The problem of the United States is not an inability to generate large increases in jobs and production. We have done that. We have done it outstandingly. Our problem is to do so in ways consistent with the longrun reduction in inflation, and with an increase in productivity and efficiency. This lies behind my plea that in considering means to improve economic performance in this recession, we do so not merely in the shortrun look at how do we immediately get some stimulus to jobs and output, but also at how we do so that we pick ways which in the long run allow us to pull down that rate of inflation, which is still going to remain too high after we have gone through all that, and ways which help us improve the growth and productivity.

---

[1] See p. 157

[2] See p. 157.

I think I had best, at this stage, turn this over to Director McIntyre.

Senator CHILES [presiding]. Thank you very much, Mr. Schultze.

PREPARED STATEMENT OF CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

ECONOMIC DEVELOPMENTS OF THE 1970'S

The Mid-Session Review of the Budget offers a time to review the economic outlook and to take stock of where our economy is. I will of course set forth the immediate economic outlook and prospects facing our country, but I would like to put those economic problems and challenges in a longer term context by looking backward at the developments of the 1970's and forward to the challenges for policy in the 1980's. Indeed as I will demonstrate, unless we deal with our immediate economic problems in a longer term context, we are likely to make little sustained progress.

In many ways the 1970's was a decade of great economic difficulty for the United States and for the entire world economy. Four major developments made this true:

First, oil. The world oil price rose more than tenfold during the decade. The U.S. oil import bill expanded almost thirtyfold and in 1980 we will be paying over $85 billion for our oil imports. And for the world as a whole, the oil import bill will exceed $300 billion. These increases in oil prices and import costs occurred not gradually but in two huge and highly disruptive surges, which simultaneously damaged our economy in two quite different ways: they siphoned off large amounts of purchasing power from consumers and created substantial recessionary forces; they also gave a sharp upward push to the price level and set in motion two new rounds of inflation.

Second, inflation, which had already gained a foothold in the United States during the Vietnam War, rose sharply at home and abroad during the decade of the 1970's. Both here and around the world, inflation averaged about 7½ percent a year over the decade. Last year for the second time in the decade inflation moved into double digits and as this year began was rising in most of the countries of the world. Inflationary expectations became endemic. By the end of the decade people had come to expect relatively high rates of inflation to be a way of life.

Third, recession. In the mid-1970's the world economy experienced the worst recession in 40 years. In 1980 recession began in the United States and economic growth slowed sharply elsewhere, triggered by the sharp runup in oil prices.

Fourth, productivity. Throughout most industrial countries productivity growth slowed sharply during the 1970's, perhaps nowhere more so than in the United States. During most of the 1960's, U.S. productivity growth averaged over 2½ percent a year. By the second half of the 1970's productivity growth had fallen to about 1 percent a year, and in 1979 productivity acutually declined.

The problem that faces our country as we enter the 1980's is to restore a healthy growth in output and employment after the current recession while dealing effectively with the three major legacies left by the decade of the 1970's:

Inflation: we must contain the dangerous oil price component of inflation and reduce the remaining and far too high underlying inflation rate.

Energy: we must adjust our economy to a world of sharply-higher energy prices and reduce our vulnerability to OPEC supply and price decisions.

Productivity: we must take major steps to improve the efficiency, productivity, and competitiveness of the American economy.

THE RECENT PAST

Over the past year, in the United States and around the world, the most pressing economic objective has been to isolate, to quarantine, and to contain the surge of inflation initiated by the 125 percent increase in world oil prices. Every country, the United States included, has sought to make sure that this large inflationary shock did not spill over and infect the rest of the economy. If wages, salaries, and other money incomes were to rise sharply in an effort to keep up with the higher consumer prices for energy, then business costs would rise dramatically, inducing rapid price increases and threatening a self-sustaining wage-price spiral at double-digit levels. Monetary and fiscal policy have had to be aimed at creating an overall economic environment in which it was hard to raise money incomes excessively. The wage-price standards aimed at wage and price moderation more directly.

During most of 1979 this "containment" objective was met. Inflation, as measured by the consumer price index did increase at a 13 percent rate. However, most of that increase stemmed from two sources; the huge rise in energy prices themselves and the associated increase in interest rates, particularly mortgage interest rates, whose impact on the cost of living is significantly exaggerated in the consumer price index. Outside of these two areas, the rate of inflation in consumer prices during the first ten months of 1979 was about 7½ percent, varying from time to time because of fluctuations in food prices. And despite the sharp overall rise in the consumer price index, wage increases did not accelerate and remained relatively moderate throughout most of 1979.

At the very end of 1979, and more strongly in early 1980, successful containment of the oil price bulge was threatened by a number of developments. Overall, prices began to rise at an 18 to 20 percent annual rate. Although much of this additional acceleration was directly attributable to further large increases in energy prices and mortgage interest rates, and to the indirect effect of energy prices on industrial costs, the rate of increase in other prices accelerated. Inflationary expectations clearly took a leap upward. Since the Federal Reserve, quite properly, refused to accommodate this large additional jump in inflation by increasing the growth in the money supply, both short-term and long-term interest rates surged. In addition, the rate of increase in wages begain to accelerate. Under these conditions it was necessary to take vigorous action to resverse these trends before they did permanent damage. Working with the Congress and with the Federal Reserve, the President took such action. He proposed a program of budget reductions, and the Congress subsequently moved toward making these cuts a reality. Selective credit controls were imposed to halt excessive use of credit. The Federal Reserve also moved under its traditional powers to restrict the increase in credit. Taken altogether these actions were substantial and had a major effect—perhaps more quickly than anyone had believed possible.

Very shortly after these steps were taken interest rates began to decline; the subsequent reduction was unprecedented in its speed and magnitude. At the present time, short-term market interest rates are less than half of what they were at the peak and long-term rates have also fallen substantially. Inflationary expectations, while clearly not evaporating, have been substantially reduced.

Inflation has slowed. The 18 to 20 percent price inflation rate of early this year has slowed sharply. [The June consumer price index continued to show the lagged effects of earlier increases in mortgage interest rates.] In subsequent months, however, decreases in mortgage interest rates should significantly slow the rise in the consumer price index. Inflation as measured by the CPI may fall significantly during the next several months. However, the underlying or core rate of inflation is now running at something like 9 to 10 percent a year.

ECONOMY ENTERING STEEP RECESSION

While major improvements in inflation and interest rates have occurred in the past three months, the economy has also entered into a fairly steep recession. The unemployment rate increased from the 6 percent level which characterized 1979 and early 1980 to about 7¾ percent in May and June. Between February and June, total employment fell by 1.4 million persons. By June, industrial production was 7½ percent below January. Domestic automobile sales in June were 30 percent below their fourth quarter 1979 level; and housing starts at 913,000 in May had fallen nearly 50 percent below their year-ago levels. In the second quarter real GNP declined at an annual rate of 9.1 percent below its first quarter peak.

Almost 90 percent of the drop in GNP in the second quarter was accounted for by declining production of automobiles and housing. Similarly, the overwhelming part of the fall in employment from February to May occurred in the automobile and construction industries and their supplying firms. In June, however, the nature of the recession changed. Production and employment cutbacks—on a more modest scale—spread to many other industries as inventories were brought into line with sales.

Evidence has begun to accumulate that the severest part of the decline is behind us and some harbingers of a later upturn have begun to appear. The decline in automobile sales seems to have ended and at least a small increase may have occurred. Housing starts rose a sharp 30 percent in June. Real personal consumption expenditures, excluding automobiles, rose by about three-fourths of a percent in June, after falling in the earlier months of the year. And in the first two weeks of July, initial claims for unemployment insurance, seasonally adjusted, fell substantially below their June level.

It is a fair question to ask to what extent the recession was brought on by the anti-inflationary actions taken last March and to what extent these actions were necessary. It is probably true that failure to act last March might have postponed the decline in the economy; it may be that the recession could have been avoided for a time by the continuation of credit extensions at a very rapid pace. But to have avoided acting, in the face of rising inflation and accelerating expectations, would have led to a longer period of exceedingly high interest rates, would have threatened another rise in the hard-to-eliminate underlying rate of inflation, thus in the long run producing a much worse fall in employment and output.

SHORT-TERM OUTLOOK

Two of the major factors that caused the present recession are now in the process of correcting themselves. The first was the very rapid upsurge in inflation, especially during the early months of 1980, which in combination with relatively moderate increases in wages, led to a sharp fall in consumer purchasing power. This is how last year's large oil price increase exerted its recessionary force on the economy. Conversely, the decline in inflation that we have seen and that is in prospect will sharply slow this erosion of purchasing power and thereby moderate one of the major depressing forces on the economy.

Similarly the economic decline in which we now find ourselves can be importantly traced back to the surge in interest rates that accompanied the rise in actual and expected inflation late last year and early this year. The effect on housing was particularly sharp, but throughout the economy the high interest rates tended to depress economic activity. The recent dramatic fall in rates should, after a time, begin to set in motion conditions under which the recession can be halted and recovery began. This has already begun to take place in housing.

A third favorable factor is the failure of inventories to accumulate excessively during the recent period. This recession, unlike the one in 1974, was not preceded by a speculative inventory boom. Moreover, during the recession to date, businessmen have moved quickly to reduce inventories as sales have fallen. While these prompt adjustments in production contributed to the steepness of the decline, they also insure that there remains no large overhang of excess inventories still to be worked off once sales stop declining.

DETERMINING THE LENGTH AND DEPTH OF THE RECESSION

While there are a number of important forces working to moderate the decline and turn recession into recovery, there are still two important questions the answers to which will be critical in determining the length and depth of the recession. First, will consumers who earlier this year appeared to be buying ahead to beat inflation simply return to more normal buying habits or, as they observe the layoffs which have been occurring, will they retrench and sharply cut back their buying? While the evidence is not all in, the behavior of retail sales in June suggests a favorable answer to this question.

Second, to what extent will businessmen pare back their investment plans during the recession? In all postwar recessions, businessmen have tended to cut back somewhat on their investment spending compared to previously-announced plans, and this one will be no exception. But in some recessions the cutback was relatively mild, while in other cases it was substantial. This has been the most widely-advertised recession in history—it was being predicted but failed to show up all through 1979. As a consequence it is quite possible that business investment plans were drawn up with the possibility of recession in mind and the actual appearance of the recession need not lead to a large cutback of investment spending. So far the surveys of business investment intentions indicate that plans will be relatively well-maintained, but, again, the final evidence is not in.

On balance, it appears that the pace of the recession is moderating and that the trough of the recession may be reached before the end of this year. 1981 should see a rather slow recovery. Since the large rundown in inventories which often accompanies a recession does not appear in prospect for this recession, the subsequent boost to recovery occasioned by a sharp turnaround in inventory investment will also be absent.

Table 1 summarizes the main features of the short-term economic outlook as we now see it. Over the four quarters of 1980, GNP should decline by some 3.1 percent. From its peak in the first quarter to its trough in the fourth quarter, the decline should be 3.4 percent. This is the pattern of a recession that is steeper than the three very mild recessions of the postwar period, but substantially smaller than the very large decline of 1974–75.

TABLE 1.—ADMINISTRATION'S FORECAST

	1980 fourth quarter	1981 fourth quarter
Real GNP (percent change)	−3.1	2.6
GNP deflator (percent change)	10.1	9.7
CPI (percent change)	12.0	9.8
Unemployment rate (level)	8.5	8.5

Over the four quarters of this year, inflation, as measured by the CPI, should run about 12 percent. The worst of the inflation, however, is behind us. Our forecast implies an increase in the consumer price index over the second half of the year of 8¼ percent. In 1981, consumer prices should rise by 9.8 percent. About one-half of 1 percent of this 1981 increase reflects the 10-cent/gallon gasoline tax, which the President will ask the Congress to enact next year.

Unemployment should rise to about 8½ percent by the end of this year, may increase just a bit further early in 1981, and then return to 8½ percent by the fourth quarter.

The budget consequences of this forecast are shown in detail in the Mid-Session Review document. The recession and Congressional repeal of the President's gasoline conservation fee together result in a $15 billion decline in revenues in fiscal year 1980 and a $24 billion decline in fiscal year 1981. At the same time, the changed economic conditions are expected to increase outlays by $7 billion in fiscal year 1980 and by $11 billion in fiscal 1981. Faster spending by the Department of Defense and unavoidable outlays such as those associated with the eruption of Mount St. Helens and the influx of Cuban and Haitian entrants are estimated to increase outlays by $2.8 billion in fiscal year 1980 and $11 billion in fiscal year 1981. In sum these result in a fiscal 1980 deficit of $61 billion, up $24 billion from the March estimate. The fiscal 1981 budget moves, in the absence of any other policy changes, from a surplus of $16.5 billion to a deficit of $30 billion.

DEVELOP LONG-RUN ECONOMIC RECOVERY PROGRAM

The economic forecast I have presented foresees an end to the recession before the end of 1980, followed by a slow recovery. The Administration considers that this outlook is not satisfactory. While recovery will occur, it will proceed at a pace insufficient to reduce unemployment significantly. Although inflation will slow, it will remain far too high. The Administration, therefore, will work with the Congress to develop a long-run economic program aimed at improving the prospects for non-inflationary and sustained recovery. In designing programs to assist economic recovery, it is absolutely vital that we do so in ways which attack fundamental structural problems and not merely inject a traditional anti-recession stimulus into the economy.

To drive home this essential point—that economic policy actions aimed at improving the economy must be designed in the light of long-run considerations—let me digress for a moment on some recent economic history. Tables 2 and 3 bring out a very critical set of facts. Over the past three years (prior to the beginning of the current recession) and over the decade of the 1970s taken as a whole, the American economy strikingly outperformed all other major countries in providing jobs. Indeed, the U.S. performance in this respect is amazing. Not only is it true of total jobs but the relative performance is even more noticeable when it comes to manufacturing jobs. Over the past three years manufacturing employment in France, Germany, the United Kingdom and Japan fell; in the United States, on the other hand, manufacturing employment rose by some 9 percent. Over a longer period—the entire decade of the 1970s—manufacturing employment in the United States rose while it fell sharply in all of the major industrial countries. While some of our favorable employment performance reflects lagging productivity growth, much of it results from very large increases in output. As Table 3 shows, the United States also performed exceedingly well in terms of the increase in industrial production. U.S. industrial production increased much faster, over the past three years and over the decade as a whole, than that of any major industrial country except Japan. Even they were not far ahead of us.

TABLE 2.—PERCENT CHANGE IN TOTAL EMPLOYMENT

	1979 fourth quarter versus 1970 fourth quarter	1979 fourth quarter versus 1976 fourth quarter
Germany		
France	−3	3
"Big 4" European countries	−1	−2
Japan	1	2
United States	10	4
	24	12

Source: OECD Main Economic Indicators.

TABLE 3.—PERCENT CHANGE IN INDUSTRIAL PRODUCTION

	1979 fourth quarter versus 1970 fourth quarter	1979 fourth quarter versus 1976 fourth quarter
Germany		
France	26	11
"Big 4" European countries	33	6
Japan	28	9
United States	51	21
	41	15

Source: Federal Reserve Board.

SHORT-RUN ECONOMIC STIMULUS INADEQUATE

This set of facts has an important implication that we should bear in mind when designing policies to improve what would otherwise be an unsatisfactory recovery: The problem of the U.S. economy is not an inability to generate large increases in jobs and production. Indeed, in this respect we have far outperformed other major countries. Rather, our problem is to produce additional jobs in ways that are consistent with a simultaneous reduction of inflation and an increase in productivity. The major challenge therefore is not to produce a traditional short-run economic stimulus aimed solely at increasing sales and output but a longer-run tax and economic program that, in the process of generating jobs, also contributes toward lower inflation and higher productivity.

I would like to discuss briefly with you some of the considerations which ought to go into the design of a longer term economic policy aimed at improving performance.

While the rate of inflation has been brought down substantially from the 13 percent of 1979 and the 18 to 20 percent of early this year, the core or underlying rate of inflation probably now runs at something like 9 to 10 percent a year. The most important task of economic policy will be to encourage a healthy growth in jobs and output during the economic recovery while at the same time unwinding that underlying rate of inflation which remains far too high. Meeting this very challenging objective will require two approaches:

First, long-run monetary and fiscal policies to control the growth of spending, to keep reasonable restraint on the growth of aggregate demand in the economy, and so to help bring about a gradual slowdown in the growth of hourly wages, salaries, and other costs;

Second, supply and structural policies designed to raise productivity and efficiency and to increase the rate at which output and employment can increase without setting in motion inflationary pressures.

In other words, we need to have both demand policies and supply policies.

CONTROLLING THE GROWTH OF DEMAND THROUGH MONETARY AND FISCAL POLICIES

If inflation is to be reduced in the long run, the Nation's monetary and fiscal policies must be geared toward reducing the growth of total public and private spending. That is, we must over time reduce the growth of nominal GNP. In one sense this is simply a truism. The rate of growth of nominal GNP is equal to the growth of output plus the rate of inflation. If, for example, real output grows by 3 percent and inflation is 10 percent, then nominal GNP will grow by 13 percent. Given a fairly steady advance in real output, a long-term reduction in inflation necessarily requires a decline in the growth of total spending measured in dollar terms, that is a decline in the growth of nominal GNP.

But this is also more than a truism. There is a momentum to interited inflation as prices and wages chase each other, influenced by expectations about inflation in the future. Unless some force actively works against that inherited inflation, it tends to keep going unabated. So if monetary and fiscal policy year after year simply aim at a continuation of the prior year's growth in nominal GNP, or total spending, then inflation is likely to perpetuate itself. Indeed because our businessmen, consumers, and financial markets have become infected with inflationary psychology after a decade of inflation, such a policy might lead to an acceleration of inflation. Long-run reduction of the underlying rate of inflation therefore requires that economic policy aim, on the average, to produce restraint on the growth of spending and thus a decline in the annual growth of nominal spending.

INCREASED LONG-TERM RESTRAINT NECESSARY

This need for long-term restraint in monetary and fiscal policy does not imply that policies cannot respond to changes in economic conditions from year to year. However, on the average, more restraint and greater caution will be required over the years ahead than would have been warranted or required were we in a period of price stability.

In that context, long-term supply and structural policies take a new meaning. Supply-side economics is not an alternative to demand restraint, but a complement. To the extent that supply and structural policies can speed up productivity and reduce the growth of costs and increase the competitiveness and flexibility of the economy, they thereby reduce inflationary momentum. The long-term demand restraint that is necessary to lower inflation becomes more and more compatible with sizable growth in output and in employment. Or, to say it another way, to the extent that we can speed up the growth of supply and increase the flexibility of the economy, the needed slowdown in nominal GNP can result in a quicker reduction in inflation and a faster growth in output.

Similarly, the long-term anti-inflation requirement for demand restraint has important implications for any tax measures which might be adopted to help speed recovery. In particular, it is not enough to pay attention to the immediate year's budgetary consequences of a proposed tax reduction. It is essential that the longer term revenue loses be carefully evaluated in terms of budget prospects over a number of years in the future. We must bend over backwards to assure that the "out-year" revenue losses from any proposed tax reduction are consistent with long-term fiscal and budgetary restraint. Otherwise, any immediate gain in output and employment from such a tax cut may be dissipated in later years by renewed inflationary pressures.

SUPPLY AND STRUCTURAL POLICIES

A substantial and durable increase in the flexibility of the American economy and of the growth of its productivity will require a number of supply and structural policies over the years ahead. Among these will be policies—some of which have already been enacted—to adjust our economy to higher energy prices and to reduce its vulnerability to supply and price decisions made abroad. Improving long-term economic performance also demands a continuation of deregulation and regulatory reform efforts already underway. It will most assuredly require that we take steps to increase the Nation's capital formation.

We do not know all of the reasons for the recent decline in the growth of American productivity, but we do know that reversing that trend will demand significant increases in the share of the Nation's output devoted to investment. That investment share will will have to grow in the 1980's for a number of reasons. There will be substantial new needs for direct investment in alternative energy sources. The adjustment to higher energy prices will also levy substantial investment requirements on the economy indirectly as the Nation replaces large parts of its capital stock made obsolete by higher energy prices. Environmental and related objectives will continue significant investment. In addition to all of these requirements, we must speed up the increase in capital stock per worker as a prerequisite to an increase in the growth of productivity.

It is not likely that the requisite investment will be forthcoming without tax measures aimed at increasing investment incentives. Restraint in Federal spending, if steadfastly pursued, will free national resources for such use through tax reductions to increase investment.

SUPPLY SIDE TAX CUTS

However, we must all recognize that supply-side economics cannot provide a quick and painless way to cure inflation and speed growth. You cannot raise Federal revenues by cutting taxes. Federal revenues do indeed tend to rise year after year as nominal incomes grow. In the year after a typical tax cut, revenues will usually continue to rise since tax cuts are seldom large enough to offset the effect of income growth. Moreover, income growth tends to speed up somewhat after a tax cut so the net loss of revenues is less than the initial tax cut. But it is utter nonsense to attribute to the tax cut the absolute rise in revenues in the year after the cut was made. Faulty analysis of this point has plagued us ever since the 1964 tax cut.

Those who say that a tax reduction will increase GNP by such a large amount as to eliminate the revenue loss simply have not looked at the arithmetic. Roughly speaking, an additional dollar of GNP will produce about 20 to 25 cents of additional revenue. That is, the relationship is about one to four or five. A $40 billion tax cut, for example, must generate $160–$200 billion of additional GNP to provide enough additional income so that the initial tax loss is wiped out. Moreover, it does no good to produce additional spending unless it is matched by additional supply. Otherwise, we will simply get inflation. There is absolutely no body of evidence which suggests that for $1 of tax cuts, however carefully designed, we can expect $4 to $5 of increase in GNP supplied to the economy.

Moreover, supply-side tax cuts cannot raise productivity by a large enough amount or quickly enough so that we can ignore the demand/increasing effect of such tax cuts. Investment-oriented tax reductions, by stimulating investment, can indeed improve the prospects for productivity growth. But the payoff is a long-term one. The magnitude of the productivity improvement is likely to be moderate in terms of how far it reduces the inflation rate or raises the Nation's potential growth rate. Raising the historical 2 percent rate of productivity growth by say ½ percentage point represents a 25 percent increase in the productivity growth rate. It is unlikely to be achieved by some modest investment incentive. When realized it would itself tend to lower the underlying inflation rate from say 9 percent to say 8½ percent—a highly worthy but hardly revolutionary accomplishment. This country does need responsible measures to increase investment. But exaggerated claims, which suggest that we will get such a large supply response that we can ignore demand-side economics, do disservice to the cause of supply-side economics.

We cannot use supply-side tax cuts to escape the need for long-term demand restraint and for careful attention to the long-term budgetary consequences of tax reductions.

Mr. Chairman, as I said earlier, this Administration is deeply concerned by the economic prospects that face the Nation. The prospective rise in unemployment and the fact that it fails to decrease in 1981 is highly troubling because of the human suffering it entails, the social dangers it poses, and the debilitating effect of prolonged slow growth on investment and productivity. The rate of inflation that we foresee for 1981 and future years will also be too high in the absence of further policies to correct the situation. We intend, therefore, Mr. Chairman, to work closely with the Congress toward the development of policies on both the demand and supply side of our economy to meet the problems I have outlined.

ASPECTS OF TAX CUT IN 1981

With respect specifically to taxes, the Administration believes that a tax cut may turn to be appropriate and desirable in 1981. But by waiting to make a final decision we gain several important advantages. First, we will have a better picture of the economic situation on which to base judgements about the magnitude and pattern of a tax program. Second, before deciding on the magnitude of a tax reduction we ought to make sure that the spending restraints proposed by the President last March and contained in the First Concurrent Resolution of the Congress are actually being achieved. Finally, and most importantly, we will get a much better tax cut by taking the time for responsible action. The tax cut we want must be a carefully-designed part of a long-range economic improvement program, not simply a traditional anti-recession stimulus. As I have been at pains to point out, we need to pay attention to both demand-side and supply-side economics; and to make sure that any tax reduction does not have excessive "out-year" costs. Otherwise, by violating the demand-side conditions of economic policy, that tax cut will lead to inflation. Tax burdens are rising and will need to be reduced. But it is absolutely essential to the long-run health of our economy that when tax burdens are reduced we put additional dollars back into the private economy in a way which accomplishes long-term structural objectives.

And so, Mr. Chairman, we believe that in considering measures to deal with today's economic challenges, we must specifically evaluate how they meet the requirements of sound policy along four dimensions: on the demand side, on the supply side, in the period immediately ahead, and in subsequent years. With respect to tax reductions, the Administration position has been and continues to be that they be developed with great care and deliberation to satisfy these criteria for long-term structural improvement, and not be hastily enacted simply as a quick stimulus package in an election year.

Senator **Chiles**. We will now hear from Mr. McIntyre.

STATEMENT OF HON. JAMES T. McINTYRE, JR., DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. **McIntyre**. Mr. Chairman, members of the Committee, Mr. Schultze and I are very pleased to be with you, as you begin your deliberations on the second budget resolution for 1981. This has already been a very difficult year for those of us who work in the Federal budget process, but I know that cooperation between this Committee, the House Budget Committee, and the Office of Management and Budget will lead to a satisfactory result by the time we have finished with the 1981 budget.

CONGRESSIONAL ACTION CONSISTENT WITH PRESIDENT'S POLICY

Although the administration does not agree in detail with all of the actions taken by the Congress on the 1981 budget, congressional action to date has been consistent with the President's policy of fiscal stringency. We are particularly pleased by your success in getting prompt and responsible action on a reconciliation bill that will result in substantial outlay savings in 1981. We hope that there will be similar prompt action by the House. Enactment of such a reconciliation bill will be a significant milestone in the continuing efforts by the Congress and the administration to maintain appropriate budgetary discipline.

MID-SESSION REVIEW ESTIMATES AND THEIR IMPLICATIONS

On Monday we issued the Mid-Session Review[1] of the 1981 Budget, revising budget estimates for 1980, 1981, and subsequent years. I would like to summarize those estimates and their implications for your future actions with you today.

The Mid-Session Review estimates reflect a continuation of the administration's policy of budget restraint. The budget revisions that the President submitted to the Congress in March were the product of lengthy consultations between the President, his senior advisers, and the leadership of the Congress. The policy of budget stringency that was agreed to then is being continued in this Mid-Session Review to help restrain inflation. The Review proposes no new spending initiatives.

Although administration policies are essentially unchanged, as you are aware, the budget numbers are not. The estimated budget deficit in 1980 is now $61 billion, an increase of $24 billion from our March estimate. Similarly, the $16.5 billion surplus presented in the March budget revisions is now estimated to be a $29.8 billion deficit. The largest part of these changes is explained by a relatively small number of items.

---

[1] See p. 263.

TABLE 1.—BUDGET TOTALS

[In billions of dollars]

	1979 actual	1980 estimate			1981 estimate		
		January	March	July	January	March	July
Receipts	$465.9	$523.8	$532.4	$517.9	$600.0	$628.0	$604.0
Outlays	493.7	563.6	569.9	578.8	615.8	611.5	633.8
Deficit, current estimate	−27.7	−39.8	−36.5	−60.9	−15.8	16.5	−29.8
Budget authority	556.7	654.0	655.8	653.7	696.1	691.3	707.2

INCREASED FEDERAL SPENDING

Federal spending has been revised upward by $10 billion in 1980 and $22 billion in 1981. These increases are due largely to three factors: The revised economic outlook; higher spending for defense, reflecting more rapid spendout rates and higher costs for pay, fuel and other purchases; and unanticipated events such as the eruption of Mount St. Helens and the recent influx of Cuban/Haitian entrants.

DECLINING RECEIPTS

At the same time, receipts have been revised downward sharply—by $15 billion in 1980 and $24 billion in 1981. These downward reestimates are caused largely by lower incomes resulting from the recession and by congressional repeal of the President's gasoline conservation fee. The mid-session review estimates continue to include the administration's motor fuels tax proposal, but the effective date has been delayed to next spring. This tax remains necessary as a means of helping to reduce our Nation's energy consumption and dependence on foreign oil.

ECONOMIC ASSUMPTIONS

The economic assumptions on which the mid-session review estimates are based reflect the more rapid and severe economic downturn that has occurred since we last presented budget estimates to this committee. The unemployment rate, which reached 7.75 percent in June, is now expected to rise to 8.5 percent by the last quarter of this year. Economic recovery is expected to begin around the end of the year, but to proceed slowly during 1981 with unemployment remaining at about 8.5 percent in the absence of policy changes.

Inflation as measured by the CPI is projected to moderate substantially from the high rates experienced during the first half of this year. Measured fourth quarter over fourth quarter, the CPI is projectd to increase by 12 percent during 1980 and slightly less than 10 percent during 1981. This improvment is welcome but it is not enough. We must continue to reduce inflation to establish a solid foundation for sustained economic growth. Continued restraint on Federal spending must be at the center of this effort.

These economic prospects are not acceptable to the administration. Policy measures to increase investment, productivity and economic growth—with beneficial effects on unemployment and inflation in later years—will be developed carefully and in close consultation with the Congress and others in the months ahead. With respect specifically to taxes, the administration believes that a tax cut may turn out to be appropriate and desirable in 1981.

CONTINUE COURSE OF SPENDING RESTRAINT

The pressures that this committee will face in its deliberations on the second concurrent resolution will be greatly intensified by the deeper-than-anticipated recession that we are now experiencing. But a fundamentally sound fiscal policy requires that we stay on the course of spending restraint that was established jointly with the Congress earlier this year. I look forward to working with this committee in that effort in the months ahead.

Mr. Chairman, that concludes my formal statement. Mr. Schultze and I will be glad to answer your questions.

CHANGED ECONOMIC ASSUMPTIONS

Senator CHILES. Thank you, Mr. McIntyre.

We have been listening, starting yesterday, to several economists, a series of them, and today to Dr. Rivlin, and of course, as your numbers begin to break, I think the question that has been most prevalent on our mind is how we could have these kinds of swings, we find that when we left here for the recess, we note our spending figures for 1980, we revised them upward, and we thought we had them in the neighborhood of $40 billion plus, and we come back and we find that they are in the neighborhood of $61 billion.

How can, you know, sort of that action happen, after we have passed our third concurrent resolution, after we have gone through all of the kinds of arguments, as has been brought up here today for hours, over $100 million in the conference committee, between the House and the Senate, and then find that spending decisions are something that raise those kinds of numbers?

Mr. MCINTYRE. It really is not a spending decision.

Senator CHILES. Spendout decision, maybe.

OVER HALF OF DEFICIT INCREASE DUE TO REDUCED RECEIPTS

Mr. MCINTYRE. No; not even spendout. A significant amount of the increase in the deficit in 1980, from the March numbers, is due to the decreases in receipts. For example, just as a result of changed economic conditions, receipts have dropped by some $10.7 billion in 1980.

In addition to that, the loss in revenues from the repeal of the gasoline conservation fee, by the Congress, reduced receipts by some $3.4 billion in 1980. The spending increases in 1980 amounts to about $10 billion, I believe.

So, as you can see, well over half of the increase in the deficit in 1980 has been due to the decrease in receipts.

JUSTIFICATION FOR INCREASED SPENDING DECISIONS

Senator **Chiles**. Let us talk about the $10 billion in increased spending. We have put in figures for disaster, we put in figures for the refugee situation, anticipating those problems. Where did we miss the target, or the goal in providing for sufficient moneys for that, and what are the other spending decisions?

Mr. **McIntyre**. Well, the spending changes are from the President's March estimate, not from your first budget resolution. From the President's March estimate, in the three categories that I mentioned, changed economic conditions, defense, and then the category that I call other necessary changes. We can talk about that, if it is of interest to you.

In the area of changed economic conditions, the spending figures have increased by about $7 billion, and if you look on page 12 of your Mid-Session Review,[1] you can get some of the details, you can see the details of where the additional spending would go. Unemployment——

Senator **Chiles**. Maybe it would help me if we work from the numbers. You are working from your March, but if you can refigure that, extrapolate that for me, we can understand better here. I think if we are working from our third resolution, in other words, we had $47 billion as a deficit when we left, and we now find it is $61 billion. So it is that $14 billion, the way we are looking at it.

When you go back to your March figures, that does not mean much to us now, because we were not using those figures for a long time.

Mr. **McIntyre**. It is very difficult for me to go in and deal with the totals in the budget resolution, without having sat down and actually prepared the differences.

Senator **Chiles**. Get Dale McOmber back there to help you with that. He has got it all in his head.

Mr. **McIntyre**. Mr. McOmber says even his awesome talents would not permit him to do that today, and we need a little information to make sure that we understand exactly where the Senate is on some of these items, to help us do that.

So we would be glad to try to work out such a comparison with you.

Senator **Chiles**. All right, I did not realize it was going to be that difficult.

UNANTICIPATED ITEMS NOT IN SECOND BUDGET RESOLUTION

Mr. **McIntyre**. I found that nothing in this job is easy, Senator. It is always complex and difficult.

I can tell you some things that are not in the second budget resolution. For example, we have an increase in unemployment compensation benefits that is not included in total in the second budget resolution. An increase in the Federal Savings and Loan Insurance Corporation, which provided support for some of the savings and loans that were having some difficulties in the spring, was not included in the second budget resolution.

---

[1] See p. 277.

Some of the entitlements programs, such as Medicare, require additional funds that are not anticipated in the second resolution. So those are some of the types of programs that fall into that changed economic conditions category that are not included in the second budget resolution.

Senator Chiles. Well, I think because it would be helpful for us if you would, for the record, if you could give us a comparison, or show us that $14 billion, where that breakdown is, how much of it is lost revenue, how much is additional spending.

Mr. McIntyre. You are talking about the total deficit now?

Senator Chiles. That is right.

Mr. McIntyre. The spending increases amount to about $10 billion.

Senator Chiles. The total deficit, $14 billion deficit.

I yield now to the chairman.

[The following was subsequently supplied for the record.]

Differences between Mid-Session Review estimate of the 1980 deficit and the deficit in the third resolution for 1980

[In billions of dollars]

Third resolution deficit	−47.0
How the mid-session review differs: Outlay increases above third resolution:[1]	
Commerce and housing credit	2.2
Income security	1.8
Transportation	0.6
Other (net)	1.5
Total outlay increases	6.1
Decrease in receipts below third resolution	−7.8
Total increase in deficit	13.9
Mid-session review deficit	−60.9

[1] Outlays by function. More detailed programmatic analysis cannot be provided without additional information about the policy assumptions that the Senate includes in the Resolution.

Chairman Hollings. Let me yield. I am catching up with the information.

Senator Bellmon?

RECESSION THE RESULT OF DELIBERATE ADMINISTRATION POLICY

Senator Bellmon. First, let me thank the witnesses for the insight they have given us, for giving us the information that Senator Chiles has been requesting.

I would like to go back a little bit, to get some background. See if we can start off with the same place.

First, I would like to ask a mean, underhanded question. Is this recession the result of deliberate administration policy? Did anybody want what we have got?

Mr. Schultze. No, sir, No. 1.

No. 2 is, I said in my testimony, it is probable, that if we had sat on our hands in March, and did not do anything, you could have had a worse recession.

If you want to put it in its meanest way, you got the recession sooner, yes, maybe, but in our judgment if you had let inflationary expectations continue, you would have let those high interest rates stay and climb higher, and because we had have not done anything about inflation, you might have been able to do it for 2 or 3 months, but it would have hit you hard later.

MONETARY POLICY IMMEDIATE CAUSE OF ECONOMIC SLOWDOWN

Senator BELLMON. Now, let us see if we can agree on what caused the recession. What precipitated the recession? We know interest got up to—what was it, 20 percent, close to it?

Mr. SCHULTZE. Yes, sir.

Senator BELLMON. That stopped housing and it stopped a lot of consumer purchases. We know inflation was up to 18 percent and that caused some dislocations so Congress undertook a restrictive—well, mildly restrictive fiscal policy for fiscal year 1981. But we are not in 1981 yet.

What seems to have caused—then the immediate cause of the economic slowdown was monetary policy; do you agree?

Mr. SCHULTZE. No, sir.

Senator BELLMON. You do not?

OPEC PRICE INCREASES MAIN CAUSE OF SLOWDOWN

Mr. SCHULTZE. Well, like all these things, it is a matter of how you say it.

First, let me start and say what really did it. Now you have heard me today say it before and I sound defensive, but it is true, what really did it mainly was OPEC. It did it to us and it did it to other countries around the world.

In the first quarter of 1980, consumers are paying out about $80 billion more. That is bound to help push an economy down. In our estimate, that is important. Associated with that is a big inflationary surge and the Fed has an option; the Fed can put the money in to finance it or kind of sit on the money. Well, the Fed sat on the money and interest rates went up and that is the second reason.

Senator BELLMON. On the import question, we import half of our crude oil; Japan imports 95 percent of theirs.

Mr. SCHULTZE. First, our domestic oil prices now go up with foreign prices. So that as far as pricing and what comes out of consumer pocket is concerned, it is not just OPEC, it is the total. I happen to think that is good pricing policy, but in the short run it hurts you. Second, we consume about twice as much oil per dollar GNP as the Germans do, not quite that much compared to the Japanese, but almost as much. Hence, the same world oil increase ends up given oil decontrol and given the fact that we consume a lot more per dollar GNP hitting us as hard or harder than the Germans or others.

Senator BELLMON. If that is the cause of our——

Mr. SCHULTZE. It is not the only one, but——

Senator BELLMON. Well, go ahead. You were going to raise some others.

RECESSIONARY EFFECT OF HIGH INTEREST RATES

Mr. SCHULTZE. I am saying this then feeds out into a lot of other things. As you start to get this inflation, interest rates start to go up. The Federal Reserve does have an option: It can pump more money into finance that or it can keep the money supply growing pretty steadily in order to slow down economic growth, to avoid the inflation that will come out of this, and interest rates do go up. You are quite right, it was interest rates then; a secondary derived consequence that led through the economy into a recession.

My only proposition, Senator, is that reasonable people quarrel about whether that prime rate should not have gotten up to 17, 18 percent. But I think it is hard to argue about the proposition that the Fed should have kept a rein—they would have to pump so much money in and we would have had a bigger bust later on. It was the high interest rates and the Fed's tightness. But when you look at what the options were, here is where I think they did not have any real option.

Senator **BELLMON**. I am not quarreling with that. I think probably the Fed did what had to be done at that point. But my difference with them comes, if I have a difference, in the fact that having brought the economy into a downturn, whether or not the adjustment was made quickly enough to get it started back again.

Mr. **SCHULTZE**. I would say that the two big things that brought us into the downturn were the big high rates of inflation which started with oil and big high interest rates, and they are both coming down and I think they are going to help turn the economy around.

Senator **BELLMON**. Without Congress having done anything?

Mr. **SCHULTZE**. Well, I think in fact paradoxically Congress actions to move on budget stringency at least helped psychologically to bring interest rates down. So Congress helped.

OVER-CORRECTED ECONOMY WOULD RAISE INTEREST RATES AND INCREASE INFLATION

Senator **BELLMON**. What frightens me is if it is true that monetary policy more or less precipitated this present problem and that monetary policy has now been adjusted to help correct the problem, and we in Congress come along with a tax cut or spending program, we will have overcorrected and 6 months, 8 months, 10 months, somewhere out the future we will be back with 18 percent inflation and 20 percent interest rates.

Mr. **SCHULTZE**. Well, your caution and your wanting to make sure we do not overdo it, I agree with 100 percent.

I would note that, however, we do have some longer run problems which at the right time and in the right context I think might be helped with tax action. But they are for the longer run, not helping to turn the economy around right now.

Second, it is true that taxes are going to rise next year.

IMPACT OF UNEMPLOYMENT RATE ON VOTERS

Senator **BELLMON**. The problem is, and I am not a candidate, I do not know how you go into an election year with unemployment at 9 percent, which is a projection, and have to face the voters without having at least gone through the motions of trying to help improve the situation.

Mr. **SCHULTZE**. Well, first, as I indicated earlier, Mr. McIntyre's testimony indicates—we think that there ought to be a program to help this. We want to work with the Congress to get one up.

What we want to make sure is that the program to help it does something about our longer run problems and does not to use a colloquial phrase, "Goose the economy." We have to do something about productivity, we have to try to find a way to get this economy turned around without pumping up more inflation.

I do not disagree with you, except to suggest that what we need to do is go into this with some care, with some things that have longer run impact rather than an effect in the next couple of months.

Senator BELLMON. Thank you.

CREDIBILITY OF BUDGET PROCESS THREATENED BY INACCURATE FORECASTS

Chairman HOLLINGS. Let me, if the members do not mind yielding a moment, let me try to ask a few questions because I might be called back down. We have the reconciliation bill down on the floor.

To both of the gentlemen, with respect to our own credibility, you in the field of economics and management in the budget, we on the congressional side here, how do we explain being off by $16 billion in 1 month, 30 to 60 days time? Something is wrong if we are going to have any kind of clout and persuasion—influence to try to hold the line—you have to have a certain amount of credibility as you present these figures.

EXPLANATION OF QUICK BUDGET SHIFTS

How do you explain being off in spending by some $8 billion, and off in revenues by $7 billion? What is your explanation of that?

Is there lack of communication; we did not understand what you were saying, or we are not talking to each other, or we have a bunch of dummies in the Congress or in the administration doing the projecting? What is wrong?

RECESSION DEEPER THAN PROJECTED

Mr. SCHULTZE. Let me start at least. I have not done research to nail this down completely, in every recession in the postwar period the Federal Government misses in calculating its budget every recession. Even in January when we came up and testified in front of you, you may recall that we projected an increase in unemployment and a mild recession. It turns out that we did not do it right. The recession was much steeper. In fact, I think that is probably the only time a recession was called a recession in advance officially. But we undercalled it and if you look at the numbers, it turns out that 85 percent of the deficit increase, 85 percent of the deficit increase in both years, comes from two things. One is the recession which we undercalled, it is steeper than we thought. I will come back to that in a minute.

GASOLINE TAX CALCULATED IN REVENUES

The second thing is that Congress did not give us the gasoline fee; you may recall Congress repealed the gasoline fee.

Chairman HOLLINGS. That second thing we never did figure in.

Mr. SCHULTZE. In our budget.

Chairman HOLLINGS. Even in your budget, we said that money was to be held, we went along with the administration's posture on that to make sure it was not being expended. Charlie Schultze says do not spend that $10 billion; there is a Budget Committee following your admonition, we put in a rule that said you could not spend it before the second concurrent resolution. Of course, we were defeated. But at no time in balancing a budget was it ever contemplated that we are going to employ the $10 billion from the——

Mr. SCHULTZE. My only point was, it was calculated in the revenues. In the surplus, it was there. Arithmetically that is how you explain where it is.

If you want to take it out, then an even larger fraction could be explained by economic conditions.

ECONOMIC CONDITIONS THAT SUDDENLY INCREASE SPENDING

Chairman HOLLINGS. What are the economic conditions that all of a sudden accelerate spending?

Mr. SCHULTZE. Well, the key—not the only thing, but if you look at 1981, where it is most significant, look on page 12 of the Mid-Session Review,[1] these are somewhat different, these are comparisons with our March budget, not your budget resolution, but they will give you a pretty good idea. We had projected the rate of unemployment to get up to 7.2 percent by the end of this year. We now project that it will be up to 8.5 percent.

My recollection is that each 1 percent of additional unemployment is worth about $6 million on unemployment compensation and related programs. The food stamp program costs you a little more because there are more people eligible when you get a recession. Those are the big ones. Similarly, you lose revenue.

My recollection, I was working at the Council of Economic Advisers then, is that President Eisenhower submitted a budget surplus and turned around a few months later and said it is going to be a big budget deficit because we had the 1958 recession.

Chairman HOLLINGS. I am talking about—let us be more specific. This attracted my attention and the public's attention and the President's attention and finally Mr. McIntyre and I met at the White House over it. We struggled during the last budget conference over $300 to $400 million.

I was racing between three or four different groups. I had two groups of House members and the speaker and I was going between four different groups trying to find $400 million. One of the things at issue, of course, was a matter of social spending or, excuse me, let us say the issue was social spending versus defense spending. We finally agreed on a defense spending figure of $153.7 billion. Now, we were really being chastised because even in the March estimate, $153.7 billion, the President said it is all he could use. He piled it on with his Secretary of Defense and they got gold plated every morning. An article came out on how we were going for gold plating, all kinds of wastes, why the Congress is on a binge over there, political overreaction, could not even spend the money. Then we got it down and the President finally joined us on the decks of the Nimitz, and that was Memorial Day. That was on a Sunday, but by Tuesday morning with community leaders, the expression was: We cheated social programs by putting in this large amount of $153.7 billion and therefore he could not possibly sanction or go along with that budget. That is June.

---

[1] See p. 277.

Now, you are coming up here now with $157.5 billion, $4 billion more than was cheating those social programs. Congress was cheating Mr. McIntyre's social programs in June, and in the next month, the administration is $4 billion above our defense number. Now how does that make us all feel?

We have to get together and start talking the same language and find out from whence we are coming and where we are heading. You are the President's director of his budget and you would not let him get—maybe a billion out of something else but not $4 billion out and then face letting the whole congressional budget process go down. It went for 10 days, we did not know whether we were going to save the budget process. We had the Speaker of the House against us, who, incidentally the week before was with us until the President jumped places. He had to protect his ground in Massachusetts, so he jumped places. We beat each other up and we finally got it all together, 1 or 2 o'clock in the morning, and now in July to find out that you want to go up $4 billion more for 1981. You have got a figure $7 billion more in outlays and in budget authority from the end of March, April, May, June; in 90 days, you are $7 billion more and you are even above our first concurrent resolution that we caught all the hell for.

How do you explain that? That is not all this oil and OPEC and all these other things that you are talking about and take out the housing and take out that—I am talking about take you and me out back behind the barn and get this thing straight because we have a lot of work to do and I am not fiddling around, wasting my time—I mean arguing over $100 and $200 million, with our House colleagues, and they constantly chastise me, but there is the administration, and the administration has $4 billion more.

What is your comment now? What can we do about this thing so that we are going down the road together?

Mr. McIntyre. Obviously, Mr. Chairman, we need to communicate more frequently in the next several months.

Chairman Hollings. And more accurately.

ECONOMIC CHANGES THAT INCREASED SPENDING

Mr. McIntyre. I think we have communicated accurately.

Let me go through with you briefly some of the changes that resulted in increase in our estimates.

First of all, I have to say that we, I stand to be corrected, but I do not recall us debating with you over the outlay numbers. Our concern was principally about the budget authority, and the reason I say I stand to be corrected, but as I recall, I think our main concern was the program level that was implicit in the resolution numbers. Since that time——

Chairman Hollings. You have gone above that.

Mr. McIntyre. I can explain where we have gone above that.

Chairman **Hollings**. I was trying to explain it to you a month ago.

Mr. **McIntyre**. Well, there have been——

ACCELERATED SPEND-OUT RATES

Chairman **Hollings**. It was not a lack of explanation. We had it based not in gold plates and pie in the sky. We can take President Carter's signing of the Defense appropriation bill just this past December, and when signing it, he projected needs and all of these were gathered from his projected needs, not any new fanciful stuff and everything else; yet, we were having the Secretary of Defense chase around capital, still here, saying it was money that they could not possibly use. So we know about the explanation.

Mr. **McIntyre**. Our concern was with the program level that was implied by the budget authority. You would not try to determine the program level by the outlays. The outlays are spend-out estimates based on appropriations that are directly related to the budget authority numbers. What we have added, and the reason our budget authority and outlay numbers have been increased is because we have reflected revised pay assumptions. Our pay assumptions have been tied to a specific policy, a policy that is related to the professional pay survey that is made each year and we have tried to tie that to the average percentage that comes out of that survey. We made an estimate back in January and March as to what that would be. We now have more current and accurate numbers of the results of that survey. It is about 9.1 percent. So we have reflected that consistent with our policy to show the additional cost of that approximately 2 percent differential in pay. We have also reflected there the acceleration of spend-out rates for outlays.

We do not make those estimates every month. Since March, Defense Department reports to us indicate that they are spending at a faster rate than we had estimated they would spend. We have reflected those accelerations in spend-out rates in this budget; that is an outlay figure and not a budget authority figure, by the way.

PAY INCREASE FOR MILITARY PERSONNEL

Chairman **Hollings**. The budget authority and outlay figures for 1981 have increased $7 billion?

Mr. **McIntyre**. That is correct. They increased for a variety of reasons, only one of which represents a policy change from where the administration was in March. That one is the benefits that are incorporated in the Nunn-Warner proposal. We have included budget outlays to support that policy change. We are adopting a program that I think you have endorsed and that is required if we are to maintain our real growth commitments.

Chairman **Hollings**. So your budget figures now do approve Nunn-Warner and 11.7 percent?

Mr. **McIntyre**. That is one of the areas where we differed with the budget resolution policy. Our pay assumptions are tied to the annual pay survey and what our policy has been. We would give the average figure that comes out of that survey to military employees and that will be 9.1 percent according to our latest information. But the Nunn-Warner benefit is a change in policy. It is about the only significant change in policy in the Mid-Session Review that is incorporated in the increases in the defense budget.

Chairman **Hollings**. If the Senate passes the 11.7 percent, am I led to believe then that if we—if the Congress sends to you an 11.7 percent pay increase, you are going to recommend that it be vetoed?

Mr. **McIntyre**. I did not say that. I do not know what we would do if you send us that.

Chairman **Hollings**. Would you recommend it be approved?

Mr. **McIntyre**. I would have to see what else is tied to it. You have got it in your authorization bill in the Senate; it is a separate piece of legislation in the House. I think we would have to look at it and see what we would do.

Senator **Domenici**. Will the chairman yield?

Chairman **Hollings**. Yes.

COST OF MILITARY PAY INCREASES

Senator **Domenici**. What will the 6.2 percent difference cost?

Mr. **McIntyre**. As I recall, it is about another $700 million or so.

Senator **Domenici**. Thank you, Mr. Chairman.

Chairman **Hollings**. Of course, we contemplated it in our conference figure in both houses. The $153.7 billion, and now you are $4 billion above it, so there is plenty of room.

Are you gold plating? Where do you find out all those things?

Mr. **McIntyre**. I do not think we are gold plating. I think we are seriously trying to address the national defense need.

What we tried to do in the Mid-Session Review with you is to indicate to the Congress what we think the President's program would cost, due to changes in economic circumstances and the increased cost of fuel, due to increased operations, particularly the Indian Ocean and the Persian Gulf area, the faster spend out of prior year appropriations, and the pay assumption increases. None of those policies have changed since January. They are the same policies. They have been driven upwards for different reasons.

PRE-ELECTION CURE FOR UNEMPLOYMENT RATE

Chairman **Hollings**. All right, Mr. Schultze, with respect to unemployment, we are running for reelection, you have a high unemployment figure you computed to be about 8.5 percent by November 4; CBO is near 9 percent and Dr. Greenspan agreed with the CBO figure. You must have thought, since we are both running for reelection, what can we do about unemployment between now and November 4?

What do you recommend to bring that down lower than the 9 percent?

Mr. **Schultze**. We think it is going to be 8.5, not 9 percent.

Chairman **Hollings**. All right, 8.5 percent.

Mr. **Schultze**. Nothing.

Chairman **Hollings**. Nothing?

Mr. **Schultze**. What I mean is that there is nothing that can be responsibly done that is not now being done—and I want to come to that—to turn that around in a hurry.

What are actually the two biggest single things to stop that slide in unemployment and turn it around and what is happening to interest rates and what is happening to inflation, and there is nothing that I know that Congress can do that is going even closely to compare to that. We do think that in 1981 the recovery that we are forecasting here is too slow. The economy is not recovering fast enough, but we want to work with the Congress to try to develop ways not simply of getting the quicky stimulus, but of attacking short-run and long-run objectives and getting down unemployment and doing better.

QUICKIE ELECTION YEAR TAX CUT

Chairman **Hollings**. How do you propose to do that?

Mr. **Schultze**. That is what we want to talk to the Congress and the leadership about. What we do not want to do is to take our chances with what might come out in a quicky election year tax cut. That would not do any good to unemployment in the next 6 months anyway, and if you do not write it right, it is likely to do a lot of long-term harm.

SOCIAL SECURITY TAX CREDIT

Chairman **Hollings**. We know we have an increase in payroll, social security taxes come January. If we passed a tax credit, what would be quicky about that between now and when we adjourn for election day? Why is that quicky?

Mr. **Schultze**. The problem is not so much that any one thing is going to be quicky, but the kind of tax bill you are likely to get.

Chairman **Hollings**. I am talking about social security. Would anything be quicky if we passed that?

Mr. **Schultze**. No. Well, again, let me—it depends on what you are talking about.

Chairman **Hollings**. Social security tax credit, $10 to $11 billion.

Mr. **Schultze**. The Gephardt proposal?

Chairman **Hollings**. Yes.

Mr. **Schultze**. I am not saying that that necessarily is quicky. What you do not want is something that just pumps purchasing power in. For instance, what is before the Congress now is 10-5-3.

Chairman **Hollings**. Let us stick to one at a time. I want to stick to that social security tax credit.

Is there anything quickly about that if we left before October?

Mr. **Schultze**. If you pass it quickly, it is quick.

What do you get by way of a whole tax bill? Not just any one piece. There are a lot of good potential——

Chairman **Hollings**. Everybody issues the key word "productivity", but the modest mind can easily discern how you have an $11 billion increase in social security taxes starting in January and then immediately have a tax credit for it. So you have withstood the inflationary increase of taxes come January and you are giving it back to people who would have to pay it.

Mr. **Schultze**. I agree.

Chairman **Hollings**. So arithmetically, it is rather simple, clear, easy?

Mr. **Schultze**. That is.

Chairman HOLLINGS. Now, is there anything wrong just with that?

TAX CREDIT INVITES GENERAL REVENUES INTO SOCIAL SECURITY

Mr. SCHULTZE. Let me note the thing that Congress has to think about before you do; that what you will have invited is a very easy way to have the same effect as putting general revenue into social security. In this way, what you do is you can, to every constituent and voter say, we can get off your back the increase in social security payroll taxes we are going to have to levy by passing a tax credit that dollar for dollar offsets it without going through thinking about financing social security. I am not saying that is bad. All I would do before that is to have extensive hearings to see whether that is what you want to do. It may be a good idea, but it is not quite that simple. It is very important that we do it right.

Chairman HOLLINGS. There is only one way to do it; either do it or do not do it.

Mr. SCHULTZE. That is true in almost any action I can imagine. That does not mean that you do not want to consider it carefully.

Chairman HOLLINGS. We have been debating about it and talking about it all spring long. We had a whole convention about it. It has been on my TV.

Mr. SCHULTZE. But there are 70—how many Senators have sponsored 10-5-3?

Chairman HOLLINGS. I am not talking about 10-5-3. We are back to the merits.

Could it be that you would object to it on a merit basis; in essence, you would do indirectly what you would not do directly, that is, going to the general revenue——

Mr. SCHULTZE. It may end up quite possible that you will find me saying that is a good idea.

Chairman HOLLINGS. You do not need hearings. We are the ones that need the hearings.

Mr. SCHULTZE. That is right.

Chairman HOLLINGS. You do not need hearings. What if you were King, or President, would you recommend it?

OVERALL TAX PACKAGE CONCERNS ADMINISTRATION

Mr. SCHULTZE. In the first place, I happen to have been hired by a president and appointed by a president and I am not the President, and we are in the process of examining what we ought to do and I expect I will tell the President before I will go out telling the world what I think we ought to do.

To say it more seriously, it is clear that we are going to have to take some policy actions to improve this economy, no question about it. The administration thinks that on any one piece of tax legislation I am sure we might be able to come to an agreement. Any one piece.

What we are worried about is that in the tag end of the session, in an election year, what the whole package is going to look at. You can probably put in front of me a number of individual pieces of tax legislation and I am forced to say, that particular piece taken by itself, yes, I find it hard to object to. But it is the whole package I am worried about.

Chairman **Hollings**. Now you are beginning to talk sense because you talk the way we have to act.

Let us suppose we put out the second concurrent resolution and we do not call for any kinds of tax cuts in the second concurrent resolution and we are on the floor this afternoon and there is Senator Domenici, Kassebaum, Senator Chiles offers an amendment, a tax credit for social security. To offset it, the payroll tax increase is to take place in January and, of course, coordinate it so they are both effective, January 1.

Now, I am a Senator and I am going to vote on that. How would you vote? I mean, we do not have hearings, you have it before you. Do you think a majority of the Senate, or a majority of the House will vote against it, so when we come to bat in November, we are going to say you voted against social security? And you say no, I did not say we were going to vote for it. We are going to say we can get somebody with sense. Either he is for it or against it. No maybes. That is where you are, and the best made plans of mice and men * * *.

I do not know whether I can get around Senators Domenici and Kassebaum. They might offer that amendment.

Mr. **Schultze**. I am hired as an economist. I never ran for election.

I can give you the economics of it, and I think the economics of it you should not do piecemeal.

Chairman **Hollings**. You should not do piecemeal?

ASSESS LONG-TERM CONSEQUENCES OF TAX CUT

Mr. **Schultze**. You have to see what the long-term consequences of what you are doing. We have to live with this for 1983, 1984, and 1985.

While again, Senator, you can get me every time on an individual piece, many of which would make sense, I say you cannot make that policy unless you look at it altogether in a tax package and an economic program. And you have to look at the consequences, not just for next year, for 1982, 1983. What is it going to do to the budget process in 1983? I do not know that and I want to know.

Chairman **Hollings**. I have had taken off $11 billion and I have left the individual work on social security——

Senator **Domenici**. Would you yield for a question?

Chairman **Hollings**. Yes.

Senator **Domenici**. Mr. Schultze, first of all, I wanted to tell you, for things being as bad as they are, you look tremendous.

Mr. **Schultze**. You are more or less trying to say you do not deserve it?

MIDYEAR REVIEW EXCLUDES TAX CUTS

Senator **Domenici**. Since you were so certain we need to do something to do improve this economy, and I assume you mean some tax cuts that are properly targeted and have enough longevity to do the trick, why does not your midyear review here have enough room for tax cuts even if you do not want them this year?

Is it not kind of phony to tell the American people there is a $30-billion deficit when, as a matter of fact, during the living period of that resolution, you are advocating a tax cut and if it is 10, or if it is 20, or if it is 30, should it not be here now so that instead of 30, it is 50 or 60, even if you do not intend to put it into effect until March?

Mr. SCHULTZE. Senator, we discussed at great length that very proposition and decided—you may disagree with the substance of our decision— that you are not likely to get the kinds of tax cut this economy needs in an election year, No. 1. You may disagree with that.

Second, having reached that decision, we said it is not going to contribute to having the kind of deliberate and orderly decisions if we put in some lump-sum number that says come and get it. It is not that we did not think of exactly what you were saying. It is obvious, it is very probable, it is likely, that conditions are going to be such you are going to want a tax cut, some of which is going to have a 1981 effect and therefore is going to make the deficits larger than this. But we finally decided that to put a specific number in now on a technical update of the budget, when we thought the Congress in our judgment ought not to be enacting a tax cut, and when we cannot explain why we chose that number rather than some other was not good policy.

INCLUDE ADMINISTRATION'S RECOMMENDATION FOR TAX CUTS IN RESOLUTION

Senator DOMENICI. Just one further, and I will be glad to yield.

Mr. Schultze, we are talking about the budget process. One of its most severe criticisms is that it has not been able to provide a stable kind of format for the Federal Government's fiscal policy and we have been forced up and down, we have outside forces like the Federal Reserve acting prudently, acting very forceably, so things are wiggling. This is a resolution, the one we are contemplating, that is supposed to be the economic game plan as far as the Federal Government has one for all of 1981, the one we are talking about. It is not the one up until January, or January 20th, it is for the whole year. I am not asking you whether we—you obviously do not recommend that we pass it this year. I am only asking, are not you ready to recommend the number, the number for 1981 so we can put it in this resolution?

It ought to be in this resolution.

ADMINISTRATION NOT READY TO RECOMMEND SPECIFICS FOR TAX CUT

Mr. SCHULTZE. Senator, I see absolutely nothing wrong with the following: One, here is a budget resolution which tells you where the budget stands, with no tax cuts in it. No. 1. Whatever you debate about what goes in it, there it is.

No. 2, we may want a tax cut next year. We do not think this is the time to pass it. We want to deliberate further. We tell the world, quite frankly, that we will have one. We have not made provisions for it here. You are not hiding anything. You may disagree with this recommendation but at least reasonable people can back it. You are not hiding anything, you are saying we are not ready to come down to specific numbers. There is nothing wrong or Budget-busting or bad procedure about that. It is just the honest truth.

The administration is not ready to recommend the specifics of a tax cut although we realize that you want one and you tell the world that it is going to mean a larger deficit when you come down to it. I do not think there is anything strange about it.

NECESSITY FOR TAX CUT IN 1981

Senator **Domenici**. There is nothing strange about it, but it seemed to me, with all the knowledge that we have, that it is one thing for you to say Congress ought not be considering a tax package here at the end of the year because it is a quicky or the like, and yet another thing when you come up and you are giving us your final recommendations for the game plan for 1981, to not yet be ready to say after January, but in the fiscal year that we are talking about, we now know that there is going to have to be a tax cut of $30 billion and we are going to work up the pieces of it in due course with a lot of time to debate, but send the message to someone that it is not a $30-billion deficit, it is a $60-billion deficit but it is going to have a significant tax relief built into it, not passed in 1980, in a Congress that is prompted by politics, but early in 1981 when there is time to deliberate.

If there is one thing, it seems to me nobody is getting any kind of economic signals if we stay with this budget, with reference to taxes. I mean all we are getting is that maybe we need some next year. I am merely saying, first, do we or do we not need a tax cut in 1981?

Mr. **Schultze**. Probably we will, but I am not yet willing to say 100 percent. But probably, yes. We will know a lot better later on. But probably, yes.

Senator **Domenici**. What are you going to know later on that you do not know now?

Mr. **Schultze**. What we do know is in the past economic events have surprised us and we will know somewhat better 2 months from now, 3 months from now. Ultimately we do have to make a cut. Why make a cut before you have to?

BUDGET RESOLUTION DOES NOT MAKE TAX CUTS

Senator **Domenici**. The budget resolution does not make the cut, the budget resolution gives an estimate of the revenues to the Congress.

Mr. **Schultze**. And we are saying——

Senator **Domenici**. That is all it gives.

Mr. **Schultze**. We are saying, here one element, or again if you believe, and you may disagree with this, that at the moment going for a specific tax cut would not be wise then so long as you tell people that is what you are working toward and are likely to be having, the fact that you do not put a specific number in is not doing any harm to anything. And it is likely to do a lot of harm—not harm, but it is misleading—when you put a number in. When you put a tax cut, which in calendar year—people normally talk in calendar year tax cuts—1981 would be a $25 billion tax cut, it would have much less effect on that on the budget since you are part way through the fiscal year; there is a lot of room for difference here. What we are down to, Senator——

THIRD CONCURRENT RESOLUTION ON REVENUE SIDE LIKELY FOR 1981

Senator **DOMENICI**. I understand all that. Let me give it back to the chairman.

The budget law before us really expects us to do exactly what I am telling you we ought to be doing. You can put it off if you like, but what is supposed to be in the second concurrent resolution is the level of revenues expected for the year 1981, implicit in the revenue year 1981, is what you want to do about the level of revenues expected because of less revenues or tax changes up or down.

Now, we have had third concurrent resolutions, Mr. Schultze, because we have underestimated revenue expenses. What you are saying to us, you can expect a third concurrent resolution on the revenue side because we are not ready to tell you that there is going to be one in 1981, although there probably is. That is what you are saying.

Mr. **SCHULTZE**. That is right.

TAX CUT WOULD INCREASE DEFICIT

Senator **DOMENICI**. So from our standpoint, it would appear to me that really what you want to do is, you do not want to acknowledge that the deficit is not $30 billion but rather $50 or $60 billion. I do not like to acknowledge it either. I do not like to acknowledge $29 billion, but I am kind of stuck with it like you. If it is going to be $55 billion or $60 billion with a tax cut, I would just as soon tell the people now.

Mr. **SCHULTZE**. I have no objection to telling anybody that it is very likely to be larger because of that. No use pursuing this a lot further.

Senator **DOMENICI**. I am sorry, Mr. Chairman.

Chairman **HOLLINGS**. That is all right.

Mr. **SCHULTZE**. Let me make one other comment.

I happen to think that the budget process that the Congress has put in in the last 4 or 5 years is the biggest thing since sliced cake, but I do not think you ought to think of it—I do not like to think of it in a way that says you ought to be dead certain every time you come to a resolution; that says there is no time you could ever say, well, look, here is what we know now and then tell people generally we may change this. I do not see any—I do not see anything so terrible about that. Sometimes you are not ready fully to come down and make a cut on the thing. You do not have to be locked in a straitjacket on everything.

ADMINISTRATION SHOULD SUPPLY TAX POLICY FOR COMING YEAR NOW

Senator **DOMENICI**. Mr. Schultze, you do not have to worry about this budget process being a straitjacket. We had added some $30 billion in a concurrent resolution for this year we are in, and if I am reading it right, we are going to have a fourth one, because it is not a $60 billion deficit, it is more.

I assume we are going to have to accommodate them some place there. So we do that all the time. I am just saying it is rather suspicious to me and very different that you do not go ahead at the end of a year and say what your tax policy for the following year is going to be and what we are going to learn over Christmas, that we can plug in, in January or February is beyond me if as a matter of fact we are going to have a tax cut, we ought to plug it in now and let the Congress next year, if you prevail in your theory that we ought to wait, let them fill in that revenue number what tax bill next year. This resolution does not pass a tax bill. It just sets revenue estimates.

Thank you.

Chairman HOLLINGS. Senator Exon.

AVERAGE INFLATION RATE FOR FY 1981-83

Senator EXON. Mr. Schultze, what do you anticipate, from your knowledge now, the inflation rate will be for the fiscal years 1981, 1982, and 1983?

Let me phrase it this way. If we were sitting here in 1984, looking back at 1981, 1982, and 1983, what do you think the annual inflation rate average would be; 8 percent, 6 percent, 12 percent, 20 percent?

Mr. SCHULTZE. I have not looked at it in terms of an average, but let me give you at this stage what we put down for, what with some luck, you might say, we might accomplish.

If you will look at the Mid-Session Budget Review, table 27.[1]

Senator EXON. Give me the figures.

CPI ESTIMATES OF AVERAGE INFLATION RATE

Mr. SCHULTZE. I am trying to pull it out. Measured by the Consumer Price Index, it would average from 1981, I will guess the average would be, about 7.5 percent.

Senator EXON. That is for those 3 years?

Mr. SCHULTZE. Through 1985, actually. Through 1983, it will average about 8.5 percent.

Senator EXON. That squares with the testimony that we received from—that has been before the Committee. Is that not a tremendously alarming figure to you as an economist?

Mr. SCHULTZE. I would like to see it a lot lower.

Let me note, Senator, the most important thing is if every year—we will never make it every year, but just about every year—we can get it going down. It is more important that it is going down than the actual number that you hit. Even if it were 6 percent, you ought to be trying to work it down to 5 percent. You are right, 8.5 percent is too high.

On the other hand, you ask yourself, what is a reasonable target to aim for, for budget planning? You have got to say well, if we can get it down from 9.5 to 8.5, to 7.5 percent over the 3 years, I think you are making better progress.

---

[1] See p. 329.

BALANCED BUDGET FOR 1981-83 UNLIKELY

Senator EXON. And likewise, you would have to conclude that for 1981, 1982, and 1983, we are not going to have a balanced budget?

Mr. SCHULTZE. Sure, in 1981; 1982 would be awful tough; 1983, I am not sure of that. No, I would not concede that at all.

Senator EXON. Yet it was only, I think, it was only 3 months ago that I trooped over to the White House one evening and we had a big ceremony where the President emphasized to us at that time, and I believed him, that it was fundamental that we have a balanced budget at this time. The signals that I get as a new Senator up here are so confusing to me, that I sometimes wonder if I am not just wasting my time trying very desperately to bring some fiscal sanity out of this situation. I am not blaming you for this, Charlie, or the President, or us. But it is a tremendously frustrating situation for this one Senator.

Now, you feel, Mr. Schultze, I believe in your testimony, that we will be basically bottoming out of the present recession by what, the end of this year?

Mr. SCHULTZE. Sometime in the fourth quarter, yes.

RATIONALE FOR TAX REDUCTIONS

Senator EXON. And then we will be making a start on a slow recovery in 1981?

Mr. SCHULTZE. That is correct, Senator.

Senator EXON. Now, with that kind of a picture, why have a tax cut? Why do we not leave things alone?

Mr. SCHULTZE. Our judgment is at least for the moment that we ought to. Our judgment is, however, that probably over the longer term, since tax rates creep up, as inflation occurs, it pushes people into higher and higher tax brackets even without you legislating. We probably will need for that purpose, and maybe to get some business incentives in, some tax reductions. I would agree, let us not rush into it.

PUSH FOR TAX CUT POLITICALLY MOTIVATED

Senator EXON. But this matter of not rushing into it, it would seem to me like we are right back to what my friend was saying on the other side of the table. See, I do not understand if we are really concerned about inflation and balancing the budget. I do not understand either the Republican or Democratic philosophies to rush into a tax cut. I think, and I am hopeful that you and everybody that has been at that table, has said that they think that home building is picking up, automobile sales are now coming back; we are beginning to come out of this. It seems to me that whatever kind of a tax cut that we come up with, we are just going to make worse this scenario that I just went through with you.

If we were sincere, as I think both the Administration and the Congress were a year ago, now, around this table, 3 months ago at the White House, and during all of our deliberations on the Senate floor, regarding mandating a balanced budget—Mr. McIntyre will remember that he came out and outlined the budget to us in the Senate—I do not know, 3 months ago, 4 months ago, and we were still desperately trying to get a balanced—it seems to me that we have reversed signals completely. It seems to me that we are saying that this year, earlier all of us decided that we must have a balanced budget because that is the only way we are going to slow down inflation.

Now, we received testimony from everyone at that end of the table that we are going to be out of the recession and start back certainly by the first quarter of next year and yet we have to have a tax cut.

I am wondering if the tax cut idea is not more political than it is for the good of America over the long flow.

Mr. Schultze. Let me put it this way: I suspect there is some political motivation.

Senator Exon. On both sides.

Mr. McIntyre. I am not sure there is that much difference at times in what is the best interest to the country and what is political. Usually what is done politically is because people want it.

Senator Exon. Is that the philosophy of this Administration?

DECLINING PRODUCTIVITY DRIVING UP INFLATION

Mr. McIntyre. No; let me make a couple of points on that and Mr. Schultze can elaborate.

One of the reasons that we have been concerned about the economic situation is because the drop in productivity that we have seen in the last several years has been one of the factors that has been driving up inflation. We need to provide the incentives for increasing productivity, particularly those relating to capital investment incentives. We need to do this so that we can, as we do move out of the recession, to help solve some of the long-range economic problems that we see. We need to improve productivity and to deal with some of the structural problems in the economy.

INFLATION PUSHING INDIVIDUALS INTO HIGHER TAX BRACKETS

I think that those needs, along with the points that Mr. Schultze made about the inflation pushing individuals into higher tax brackets and taking away some of the discretionary disposal income because of higher inflation, are good and sufficient reasons to have periodic tax cuts. It is for those types of reasons that we think you ought to give the tax cut situation some detailed thought and not try to do just a quicky tax cut to react in the political environment of an election year in the few days that remain in this session of Congress.

TAX CUTS WOULD INCREASE DEFICIT AND ACCELERATE INFLATION

Senator Exon. If we follow that philosophy though, we certainly must tell the people that when we cut your taxes, we are going to raise the deficit which, if the traditional idea prevails, means that we are going to feel inflation that much more.

Mr. McIntyre. Not necessarily. In some cases, that certainly could be the case. If it is just strictly putting greater demand in the economy, that might happen, depending again on the capacity in which the economy is performing. But it is not necessarily the case.

I think some carefully drafted tax reductions can be achieved without accelerating inflation even though the deficit will increase slightly.

Senator Exon. Thank you.

Chairman Hollings. Senator Kassebaum.

PUBLIC CONFIDENCE IN CONGRESS OR ADMINISTRATION WANING

Senator Kassebaum. Mr. Schultze, you mentioned the piecemeal approach, and I could not agree with you more that that is why the public has so little confidence in either Congress or the administration.

But the President presented a budget in January and then he revised it and presented another budget a couple of months later. We have vacillated—attacking from one direction then another. I think if there has been any stability, in what we are doing with fiscal policy, it has been because of Senator Hollings and Senator Bellmon who have been steadfast on the Senate floor; willing to stand up and be counted with some tough votes that were not politically popular.

I think the public will respect us if we are honest in what we are saying, even if it is something that is not going to be politically popular.

ADMINISTRATION'S PROPOSAL FOR TAX CUT UNCHANGED

The President himself has said that he thought there should be a ax cut in 1981. If this is the case, I do not know why it then annot be presented, as Senator Domenici was saying, in this udget proposal. I also heard Chairman Volcker yesterday speak n lagging productivity and we have all acknowledged this prob- em. I have been here almost 2 years and we have been talking bout this ever since I came. I really do not know that anything as changed, in the way of the proposal, on the part of the admin- stration particularly. This is not an easy issue to address.

On the other hand, the longer we keep saying it, the more we isk losing credibility in the eyes of the public. So these are just ome comments because I have some other questions really but rom the conversations so far, I would certainly agree with Senator xon about the frustration we feel as freshmen Senators when we y to develop some policy that appears to be going in a certain rection. There has to be an acknowledgment for changes to occur. ut I think we all recognize there is a recession. We could not go to the type of monetary policy that we were developing without me type of recession developing.

I think it was a mistake to present a balanced budget as a arvelous achievement of the administration, when indeed it was ing to be very difficult to accomplish. I think that, again, the ly reason we came up with what we did here, that even resem- ed that, was because some Senators, and particularly the leader- ip of this committee, were willing to stand up and be pretty ugh on some votes.

INDUSTRY RESTRUCTURED TO IMPROVE PRODUCTIVITY

Mr. SCHULTZE. Let me make a comment on your comments if I might, Senator Kassebaum.

You made the point we have been talking about productivity for a long time and what have we done about it? Do not sell yourself, the Congress, and the administration too short. You know when the history books are written about the last 4 years, I include next year with it—while we spend our time properly talking about inflation and recession, what the history books are going to say is this particular couple of sessions of Congress did more to restructure American industry in a way to improve productivity than anything in the 20th century.

Do you realize by the time we are through, and it may take into next year, I hope not, this Congress will have deregulated airlines, trucks, railroads, a good chunk of banking and finance, and I hope communications. It is $175 billion worth of industry. It is the nerve fibers of America. It is what connects America physically, informationally, and creditwise. It does not show up right away, but it is going to be a big accomplishment. So let us not sell ourselves short. The Congress has done a tremendous job that 10 years ago people said could not be done.

CONGRESS SUCCESSFUL IN RESTRAINING FEDERAL SPENDING

Second, let me go to frustration. Senator Exon mentioned frustration. You are going to balance the budget and low and behold the budget is not balanced. How do you go back to your constituents? I do not know that. But there are three things that happen to the budget. What you do by way of expenditure programs, what you do by way of tax rates, and what the economy does. You can struggle to control the first two; you cannot control the third.

If this economy had the same unemployment rate through 1981 that it had when you first started debating the second budget resolution, namely 6 percent, the budget with everything in it that is now in it would be $35 billion in surplus. A difference between $35 billion in surplus and $30 billion in deficit is an economy which has gone into a recession. I am not at this stage trying to be defensive. I am saying, however, that the Congress has made some important steps in holding down and cutting spending. Now that may not show up in the aggregate numbers because unemployment is going to go up and spending is going to increase. But you have done a lot.

SEASONAL FLUCTUATION OF UNEMPLOYMENT

Senator KASSEBAUM. Would you yield, Mr. Schultze, on the unemployment issue?

Does not unemployment always increase in the summer?

Cannot we make provisions ahead, particularly when we have an economy that is down, since it is going to be harder for young people to find jobs that are usually temporary members of the work force; and women, also who are now entering the work force in ever increasing numbers, have significantly changed the guidelines by which we can judge a work force and it seems to me it would have been easy to predict this phenomena?

Mr. SCHULTZE. They take account of that. The numbers that I am talking about are adjusted for those fluctuations.

INCREASED REVENUE FROM RESCINDING AGRICULTURAL COMMODITY EMBARGO

Senator KASSEBAUM. My questions really are to you, Mr. McIntyre.

I am wondering if you have made some projections regarding the agricultural economy. As you know, Senator Dole has introduced legislation which would rescind the agricultural commodity embargo and I would like to know if you could give me an estimate of what amount of increased revenue there might be if the embargo were rescinded?

Mr. MCINTYRE. No, I cannot give you an amount of increased revenue. I can say that we think it would be unwise to repeal the embargo. The real problems about farm income have related to such things as cost of production. Mr. Schultze may have some figures on this. Charlie, as I recall, the problem with farm income is not due to prices or necessarily receipts, because I believe they are at least as high or higher than they were when the embargo was put on.

Mr. SCHULTZE. My recollection is right, we are going to export more grain than before the embargo, No. 1. At least I am 95 percent sure of that. I know farm imports are going to be high and I know grain is going to be higher than before the embargo. Corn prices are higher. There are problems.

Please do not get me wrong, but the embargo has not done it.

GRAIN EMBARGO RESULTED IN LOST REVENUES

Senator KASSEBAUM. As you know, there obviously was lost revenue because we took approximately 25 million, not quite that. It would have been probably 17 million metric tons out.

Mr. SCHULTZE. Not to the farmer because we got that back in reserves and we bought a lot of it.

Senator KASSEBAUM. That would have been outlays.

Mr. SCHULTZE. Yes.

Mr. MCINTYRE. We expected to buy it. $2.8 billion——

Senator KASSEBAUM. That has been in lost revenue from the embargo already.

EXPENDITURES TO OFFSET EFFECT OF GRAIN EMBARGO

Mr. MCINTYRE. No, I would not call it lost revenue. It is expenditures that the Government has made to offset the effect of the embargo and to insure that the farmers did not suffer as a result of that drop in prices. It is about $2.8 billion.

ADMINISTRATION MOVING TOWARD RAISING FARM PRICE SUPPORTS

Senator KASSEBAUM. According to an article in the Washington Post on July 12, the administration said that they were moving toward raising farm price supports.

I wonder what magnitude is under consideration and when we could expect a more definitive statement?

Mr. **Schultze**. That I cannot tell you.

Mr. **McIntyre**. We are right now making a thorough assessment with the Agricultural Department and working with the Agricultural Chairmen, House and Senate, about the farm program policies.

I cannot give you an exact date of when we will make some announcements or decisions about a change, if any, in the farm policies. We are working with the Congress on the issues of developing policy. As you know, there is one committee in each House and we are going to try to work something out.

There are a lot of other problems that are attendant to the farm bill discussions such as the effects of the drought in the Midwest and Southwest. We have to take into account what that is going to do to prices and crops and how we are going to deal with it.

So we are looking at that, Senator. We have not made a decision yet and it certainly could affect the budget.

Senator **Kassebaum**. Has anything been taken into account in your budget reestimate?

Mr. **McIntyre**. Since there are no policy decisions about a 1981 farm bill, we have not added anything into the estimates that would accommodate any changes in farm policy.

Senator **Kassebaum**. You are going back to exports we are going to increase. The USDA has projected that farm income would be down by 40 percent, however, and I do not know how that shakes out. But I do think there is going to be far more of an impact in the budget than has been projected by the administration.

Mr. **Schultze**. I think we have taken it all into account but Lord knows we are not perfect.

Senator **Kassebaum**. Thank you.

IMPACT OF PERCENT CHANGE IN TOTAL EMPLOYMENT ON PRODUCTIVITY

Senator **Chiles**. I wanted to ask you on table 2[1] in your statement, where you were talking about percentage change in employment. The figures do show very well for the industrial percentage, change in industrial production in table 3[2] in the United States. How was Germany, France, and Japan, how were they able to get their kinds of production with—in the example of Germany and France with a minus percentage change in total employment?

Obviously, that had to give them tremendous productivity.

Mr. **Schultze**. Is even larger than this. Look at this manufacturing employment figure. The point I was trying to make when I put the table in was not that all of this is to our credit, but that our problem is productivity; not that we cannot get big gains in unemployment. But, you are right, they had much better productivity.

Senator **Chiles**. How were they able to do that?

Mr. **Schultze**. Let me start with the honest admission that I don't know all the answers to that.

Senator **Chiles**. They just stopped importing some of their workers?

---

[1] See p. 157

[2] See p. 157.

Mr. SCHULTZE. That's how they were able to get this kind of employment performance and not have huge unemployment. Unemployment has gone up but nowhere near as much as this would indicate.

If we had their employment performance, we would have had 30 percent unemployment rates. They no longer bring guest workers in.

A lot of their unemployment is back in Yugoslavia or Spain somewhere. Not so much the actual people going home but the big growth in the labor force stopped. They did not come in anymore.

Second, for the workers, they had their productivity growth growing faster than ours. The growth in output per worker was faster.

This is for a lot of reasons. It has been faster during the whole postwar period. We started in the postwar period with productivity way up here and they haven't caught up to us yet but they have been growing faster and they are close.

For the Germans, it probably is hard to measure. It is probably pretty close now. Their growth has been a lot faster, which shows up. They invest more.

The Germans and Japanese have quite different approaches. The Germans generally let the market do it. Most of the German performance is kind of hands off although they do some.

The Japanese, on the other hand, tend to manipulate their industry more. I guess, for each country, its own culture.

The Germans have done very well with almost a complete free market approach to it but they have also invested a lot. That is important. They put more of their national output into investment than we do. We started higher. It is hard to grow as fast when you start that much higher up.

I know that is a rambling answer, but I don't know it all.

ADMINISTRATION'S SUPPORT FOR ACCELERATED PUBLIC WORKS PROGRAM

Senator DOMENICI. Mr. McIntyre, there is a large EDA bill in conference. You are aware it has been locked up in conference for 3 months. It has a $2 billion accelerated public works program in it. Does the administration support, for fiscal year 1981, a $2 billion—or any amount, when accelerated—public works program?

Mr. MCINTYRE. A local public works program?

We have grave concerns about the use of a local public works program as a countercyclical device. I believe the chairman of this committee was involved in some of those meetings, in which we raised very serious problems.

We have a report that our office compiled that I believe was made available to the committee. It indicates that local public works is not a desirable countercyclical tool.

In fact, our report shows that about 80 percent of the money in the last round of local public works was not spent at the time the study was made, which was months ago. We have some grave concerns and are very dubious about the benefit of that as a countercyclical device.

Senator DOMENICI. I was aware of that, but can I be more specific?

There is precisely a $2 billion—you call it local and I call it accelerated, and you are probably more correct because there is nothing accelerated about it, it is very slow—a $2 billion program in there. This is a triggered program.

I would like to know, since we start locking up next week, does the administration support that $2 billion program—yes or no—and if triggered, at what level?

ADDITIONAL FUNDING FOR EDA PROGRAMS

Mr. **McINTYRE**. Obviously, we are interested in getting the EDA reauthorization bill passed. We worked hard to try to get some of the additional funding for EDA programs and this particular provision. They have had this bill up, I believe, almost a year now, Mr. Chairman.

Let me give you some background.

Senator **DOMENICI**. I don't want any background if you don't have the answer. I know the background. I have been there.

Mr. **McINTYRE**. I have an answer.

I don't have a categorical answer.

Senator **DOMENICI**. Do you have an answer?

Mr. **McINTYRE**. Yes; I have an answer.

We, at one time, did talk to members of the conference committee about trying to come out with some compromise with a very high trigger rate on the countercyclical local public works provision that would have freed the bill from conference so we could get our increased EDA program.

That did not work. The trigger, I believe, was 8 percent. It would require the President to make a determination and a recommendation for an appropriation to the Congress. It was not an entitlement program, in other words.

Based on those types of conditions, we said that we could swallow that in order to get the rest of the bill. That has not been acceptable and the bill is still in conference.

Unless something dramatic happens, I think it will reside there for a long time to come. But that doesn't mean we are not in favor of getting the EDA programs reauthorized.

I would hope—and I think the chairman shares my sentiments—that we could do something about this EDA program. It is a good program.

We also have the title 5 commissions tied up. We have the Appalachian Regional Commission tied up in this authorization bill. I think it is important to try to work something out to get those programs properly authorized so that we don't work on a continuing resolution forever.

YEAR-END WASTEFUL SPENDING BY FEDERAL AGENCIES

Senator **DOMENICI**. Just one last question.

As we move toward the end of this fiscal year, Mr. McIntyre, is there any evidence that agencies of the Federal Government are going to try to spend as much money as they can because the year is almost up, even if they were spending out more slowly, and if so, is the administration going to do anything about that?

Mr. McINTYRE. If history is any guide, the agencies will try to spend money to beat the end-of-the-year lapse. Also, I can tell you that I have already notified the agencies in writing that we do not look with favor upon these attempts to spend money in a wasteful fashion at the end of the year.

Now, let me hasten to say that there are some areas where I think end-of-the-year spending is perhaps justified. There are some programs, for example, that are designed so that the money doesn't flow out until the end of the year. In some cases, it is good management practice to hold up on your spending during the first part of the year and save up so you don't get into a bind and have some emergency later on in the year that you don't have money to fund.

But I am absolutely and adamantly opposed to the wasteful spending that does occur in some agencies—we have evidence of it and you have evidence of it—just to get the money spent so they don't lose it.

We have taken all the steps we have legal authority to take in order to deal with that.

In addition to the notice I sent out to the agencies, we are working with the Inspectors General to get them involved in our efforts throughout Government to eliminate waste and fraud and abuse in Government spending. We are also working with the General Accounting Office and in my own financial management branch to try to tighten up the financial management procedures throughout the Government.

There are a couple of bills that are pending before Congress that we have commented on. Congressman Brooks has a piece of legislation that I have written a letter on and told him we would support this legislation with certain amendments which I believe he is in agreement with.

I haven't talked to him in the last few weeks.

We will work with the Congress and try to insure that we cut down on wasteful spending practices after the end of the year.

TAX CUTS FOR 1981 TO ENCOURAGE ECONOMIC RECOVERY

Senator DOMENICI. Mr. Schultze, it has been kind of implied here today that any tax cuts for 1981, because of a projected deficit without the cut, would be inflationary.

Is that true?

Mr. SCHULTZE. No.

Senator DOMENICI. Would you tell us the kind of taxes that would be good for long-term recovery and stability in our economic growth that would not, even if added to 1981's $30 billion deficit, that would not be inflationary?

Mr. SCHULTZE. I don't have a list. I can tell you some of the criteria.

Senator DOMENICI. Would you, please?

Mr. SCHULTZE. One of the criteria is that you do not have very large outyear losses. There are some tax proposals now before the Congress that come in very small and, within 5 years, they may be 15 times larger. That's one criterion. You look at the outyear revenues. There may be some tax proposals which are not inflationary in 1981, but are inflationary in 1982 and 1983.

Second, I think, to the maximum extent possible, you ought to see if you could find taxes which not only do not grow—whose losses are not too large—but at least some important part of the tax reduction should help improve productivity through investment incentives.

I think, if possible—and this is the attraction of social security related ones. We ought to very seriously consider, although there are pros and cons, measures which otherwise reduce costs, and social security, or an offset like Gephardt, is one that does that.

The exact size of the cut in 1981, I don't know. I don't have a magic number. I think it would depend in part on how well Congress ends up doing on restraint of budget expenditures.

The magnitude of the appropriate tax cut will also depend upon the magnitude of the expenditures.

Senator DOMENICI. For the remainder of your answer, assume we retain the same policies that are in the resolution.

Mr. SCHULTZE. That takes away one area of uncertainty.

I don't know the right number, but let me put it this way: I think a number of below $15 billion in this kind of economy does not make much sense, and a number above $35 billion gets too high.

Within that, there is a wide range of what might be possible.

Senator DOMENICI. Somewhere between $15 and $35 billion.

Mr. SCHULTZE. That is the wide range at this stage.

Obviously, when you finally make a cut, you will have to come down to a specific number.

Senator DOMENICI. Thank you, Mr. Chairman.

Chairman HOLLINGS. Senator Bellmon.

Senator BELLMON. Does the fact that we, in spite of our best efforts, have failed——

Mr. SCHULTZE. Can I modify that last answer?

When you get above $30 billion, I get worried, $15 to $30 billion.

CONTINUE EFFORTS TO BALANCE THE BUDGET

Senator BELLMON. Does the fact that we, in spite of our best efforts, have failed to get a balanced budget for 1981 mean we should give up?

A temptation here will be to throw up our hands and say: "We tried hard. We were going through all kinds of political pain to get a balanced budget, but it didn't work, so now let's go on the way we did prior to 1975."

Mr. SCHULTZE. I don't know how I could get my answer strong enough.

I couldn't think of anything worse.

I think Congress—as a matter of fact, both sides of the aisle, and this is absolutely nonpartisan—is to be commended for a lot of good work it has done this year, even though you will have a much larger deficit than anybody thought.

I go back to my point with Senator Exon. What Congress can do is work on expenditures and tax rates. Congress cannot control the economy, which gives you more or less deficit, depending on how it is going.

EFFORTS OF CONGRESS TO RESTRAIN FEDERAL SPENDING ESSENTIAL

Mr. **McIntyre**. Can I add a point?

I think it is absolutely essential that the Congress continue its effort to try to restrain Federal spending.

If you abandon the approach you have already undertaken, and you have made good progress in the Senate on this, the deficit will be even higher. Then we get back into a situation where it appears that everything is out of control and we get back into a very difficult problem with the financial markets and with our entire economy.

I think it is absolutely essential that you continue to pursue this effort.

Senator **Bellmon**. You say that if it had not been for what we have done, deficits would be higher.

We struggled over point ones and point twos, and now with the economy going into a slide we wind up with a $15 to $16 billion revenue loss or increases in program costs.

It makes what we do seem, frankly, sort of inconsequential. To me, trying to get the economy stabilized so we don't have these unexpected disasters is what this is all about.

CONGRESS CANNOT CONTROL THE ECONOMY

Mr. **Schultze**. Senator, it isn't that I don't want to get the economy stabilized, too, but the disaster is what is happening to the economy; not so much what is happening to the deficit. The biggest problem is the economic problem.

When you cut $1 billion out of spending, as a general proposition you are cutting a billion dollars out of the base. In normal circumstances, that will go out forever. You have a billion dollars out this year and next year.

If you add a billion, it is not just this year. It is forever according to the way things normally go. The state of the economy, however, tends to fluctuate.

We will pick up revenue when the recovery comes. We will be moving in the right direction toward balancing the budget.

Part of that is temporary. What isn't temporary is when you add unnecessarily to a spending stream, which sticks in there for year after year. By exerting the kind of work Congress has done, it may not look like much at any one point but these steps add up and they are out there in 1982 to 1985. That work keeps on. It kind of sticks with you.

EFFORTS OF CONGRESS UNDONE BY MONITORING MANAGERS

Senator **Bellmon**. Well, I see our work having been undone by mistakes made by our monitoring managers.

I don't criticize the need for having taken the action they took to raise the interest rates to slow down inflation, because that is all very necessary, but it seems to me somehow they overdid it or kept those restraints on too long, or perhaps the wrong kind of restraints were applied.

I don't know enough about monetary management to know what I would have done.

I don't think anybody wanted the results we have gotten because it will produce a large deficit and it will ultimately increase the costs of debt service which will make it more difficult to balance future budgets.

It will probably result in some political corrections—I guess that's the right word—which will either be another maybe untimely tax cut or increase in public works or some other kind of spending scheme.

To me, what we have done in Congress, which was fairly painful, has been more or less destroyed by actions taken in other parts of the Government. I don't know why we cannot cordinate our actions better.

Mr. **Schultze**. Well, two things. First, I don't think it was anything that Congress did in this regard that, in effect, was destroyed.

You will be spending less money in a lot of different areas because of what you did and you will be spending more money, say, for unemployment compensation.

Senator **Bellmon**. That's right.

Mr. **Schultze**. Given the recession, that isn't bad.

Senator **Bellmon**. But we didn't need a recession.

Mr. **Schultze**. I understand, but given the recession, the good you did still is there. Where it is offset by unemployment compensation, that, itself, isn't bad, given the recession.

Senator **Bellmon**. If you could get the folks who gave us the recession to take it back, we will be obliged to you. [Laughter.]

Mr. **Schultze**. I don't want to sit here and say I defend every jot and tittle of what the Fed did. I don't mean that. Like the old joke goes, ask yourself: "Compared to what? Ask yourself, under the circumstances that prevailed in the early part of the year, with inflation mounting and mounting, with oil prices going up, with expectations just terrible about future inflation, with wages beginning to accelerate, should the Fed have pumped a lot more credit into this in order to hold those interest rates down?

I think that would have been worse.

Then you can ask, what caused the situation that gave the Fed the trouble? There are a lot of things involved. Given what was going on, I think you would have gotten a worse result if the Fed had not done something.

RECESSION NOT AS DEEP AS PROJECTED

Senator **Bellmon**. Let me change direction a minute. I do not want to monopolize the time, but we have all, for the last 2 days, been hearing from people who seem to agree that we are in for a lengthy recession averaging 9 percent unemployment—or 8.5 percent as per your figures—for fiscal 1981, plus the balance of this year, and who knows how much further in the future.

When you look at some of the things happening in the economy, I get a little optimistic that it won't be that bad.

Housing starts have recovered rather dramatically. They are—what, 1.2 million. Auto sales are up from approximately 5 million units to over 7 million units on an annualized basis.

There are strong parts of the economy. Every drilling rig that can possibly be started up is running and you have to stand in line for 6 months to hire one of them. They are building more as fast as they can. On the energy side of the economy, the oil and gas industry, at least, is very strong.

Is there a possibility we are being too pessimistic? Your forecasts are a little less pessimistic than the CBO. Why are you less pessimistic than our own budget office, Mr. Schultze?

RECESSION SEEN ENDING SOON

Mr. **Schultze**. First, there is no one answer. It is a lot of little bits and pieces. We are slightly more optimistic than they are. There is no one answer I can give.

We have a little more investment spending, for example, but we also have employment doing a little bit better for the same GNP than they do. They improve productivity faster than we do. Their forecast of the improvement is—I hope they are right and I hope you are right on the economy. I don't want to sit here and argue there aren't grounds for optimism. There are.

When you look at it cold turkey, which we are trying to do, we are optimistic in the sense we think the recession will turn around.

It will moderate and turn around by the end of the year. We don't think it is a satisfactory outcome because it won't grow fast enough.

Saying it another way, you and I would probably agree that you can be optimistic about this recession ending.

While one has to be pessimistic until we get together and get additional policy actions is on how rapidly it will recover next year.

It is the speed of the recovery rather than the fact of there being a turnaround that is at issue.

I would agree with you. I think the turnaround is not too far down the pike.

Senator **Chiles**. I have a couple of things I would like to put in the record, Mr. Chairman.

Chairman **Hollings**. That will be included in the record.

MONITORING ECONOMIC CHANGE PROGRAM, EXPECTED CHANGE IN PRICES DURING THE NEXT 12 MONTHS

[Percent]

	May 1977	Aug. to Sept. 1977	Nov. to Dec. 1977	Jan. to Mar. 1978	Apr. to June 1978	July to Sept. 1978	Oct. to Dec. 1978	Jan. to Mar. 1979	Apr. to June 1979	July to Sept. 1979	Oct. to Dec. 1979	Jan. to Mar. 1980	Apr. to June 1980
A. All families:													
Same or down	18	19	16	13	11	12	9	8	8	13	13	10	26
1 to 2 percent	7	7	7	7	5	5	4	4	4	3	3	3	2
3 to 4 percent	9	10	10	10	10	8	7	7	6	5	5	4	4
5 percent	18	14	14	13	11	12	11	9	9	9	8	9	8
6 to 9 percent	16	13	18	17	21	17	21	20	14	13	13	11	9
10 percent or more	21	23	22	18	22	28	27	35	45	44	44	52	39
Don't know how much prices will go up	9	12	11	20	18	16	19	16	12	11	12	9	10
DK, NA	2	2	2	2	2	2	2	1	2	2	2	2	2
Mean increase	6.9	7.2	6.9	6.8	7.8	8.3	8.1	9.9	11.1	10.3	10.3	11.9	9.1
B. Families with incomes of $20,000 and over:													
Same or down	11	13	11	10	6	7	6	5	4	9	11	9	23
1 to 2 percent	8	7	6	7	6	5	5	3	1	3	3	3	2
3 to 4 percent	7	11	12	10	9	8	8	5	6	4	5	3	5
5 percent	20	16	19	16	13	13	9	9	10	8	7	7	8
6 to 9 percent	25	26	27	27	30	28	32	32	17	17	16	10	11
10 percent or more	22	23	20	18	26	30	29	39	55	53	51	63	45
Don't know how much prices will go up	6	3	5	11	10	8	10	7	6	6	7	5	5
DK, NA	1	1	(1)	1	(1)	1	1	(1)	1	(1)	(1)	(1)	1
Mean increase	7.2	6.8	6.5	6.4	7.5	7.6	8.0	9.1	11.2	10.4	10.0	11.6	9.0

[1] Less than one-half of 1 percent.

Note.—The questions were: "During the next 12 months, do you think that prices in general will go up, or go down, or stay where they are now?" (If will go up) "By about what percent do you expect prices to go up, on the average, during the next 12 months?"

Source: University of Michigan, Survey Research Center.

EXPECTED CHANGE IN INTEREST RATES

[Percent]

	May 1977	Aug. to Sept. 1977	Nov. to Dec. 1977	Jan. to Mar. 1978	Apr. to June 1978	July to Sept. 1978	Oct. to Dec. 1978	Jan. to Mar. 1979	Apr. to June 1979	July to Sept. 1979	Oct. to Dec. 1979	Jan. to Mar. 1980	Apr. to June 1980
A. All families:													
Go up	39	46	49	52	61	64	67	63	64	64	57	54	34
Stay the same	40	39	37	32	29	24	22	23	24	23	20	25	20
Go down	12	10	7	7	5	7	6	9	8	9	20	17	43
DK, NA	9	5	7	9	5	5	5	5	4	4	3	4	3
B. Families with incomes of $20,000 and over:													
Go up	35	50	47	52	62	64	68	58	63	62	54	47	28
Stay the same	49	37	41	37	31	26	22	29	25	25	20	27	19
Go down	13	10	8	6	5	9	8	12	9	12	24	25	52
DK, NA	3	3	4	5	1	2	2	1	3	1	1	2	1

Note.—The question was: "No one can say sure, but what do you think will happen to interest rates for borrowing money during the next 12 months?"

Source: University of Michigan, Survey Research Center.

Senator BELLMON. I am finished, Mr. Chairman, but let me just say one thing. I would like a little to compliment—and I don't want to overdo this—the administration for having brought us what looks to me like a fairly honest appraisal of where we are.

I can remember the year when George Schultz was down here and he brought us a budget that was roughly $40 billion in the red but he presented it to us as a balanced budget on the basis of full employment.

I don't know whether you forget that device or chose to forego it, but I think you ought to be commended for——

Mr. SCHULTZE. I can't say we weren't tempted. [Laughter.]

Senator BELLMON. For coming with what I think looks like a reasonably factual presentation.

On that basis, I will stop.

PROJECTION FOR OBTAINING A BALANCED BUDGET

Chairman HOLLINGS. I agree with you. I was in shock over the full employment budget. [Laughter.]

I never did understand that one.

In any event, the expression used, Mr. McIntyre, "when the recovery comes" and the other expression "when some additional policy action is taken to assist the recovery," I happened to ask this because I believe Mr. McIntyre believes in this balanced budget just as strongly as I do.

Now, when do you think we can work toward a balanced budget? Can we obtain it—obviously, not by 1981—but can we obtain it by 1982 or 1983?

When do you project we will come back in line?

Mr. MCINTYRE. Our long-range assumptions have the budget coming back into balance in 1982.

Chairman HOLLINGS. 1982?

Mr. MCINTYRE. Yes.

If you look at page 64 of the Mid-Session Review, [1] we are back in balance by 1982.

Let me say that those figures do not contain the effects of any tax cut.

IMPACT OF TAX CUT ON OBTAINING A BALANCED BUDGET

Chairman HOLLINGS. That is what I was going to ask.

Those figures do not contain any tax cut.

Mr. MCINTYRE. That's correct.

If you had a tax cut, the effects in 1982 of any tax cut that we would be talking about would certainly reduce receipts more than the surpluses shown on the chart.

Senator CHILES. Did you have any kind of unemployment figures for 1982 assuming no tax cut?

Mr. MCINTYRE. Yes.

I don't recall what it was. I would have to dig out the figure we have in here.

---

[1] See p. 326.

Chairman HOLLINGS. Now, we are talking right on target in the same language.

Mr. SCHULTZE. 7-7. For calendar year 1982, 7-7.

Chairman HOLLINGS. Mr. Schultze says "when the recovery comes," and then we get back in 1981 with the Congress and we have "some additional policy action."

Mr. McIntyre says: "No, we can have a balanced budget by 1982 without some additional policy action."

Is that right?

Mr. MCINTYRE. I think, without some additional policy actions, we probably would have a different forecast as we move closer to fiscal year 1982, Mr. Chairman.

Based on the assumptions that we have now, taking those assumptions out without any tax cut, we do show a surplus, but the longer the range of forecast, the more questionable it becomes, I think.

Chairman HOLLINGS. I see that going up in 1983, 1984, and 1985, a continued increase in surpluses, is that right?

This is on page 64 of the Mid-Session Review. Do I read that correctly?

Mr. MCINTYRE. That is correct.

Chairman HOLLINGS. It was not an actual balanced budget in 1982, but it is moving in the right direction, and increasing.

Mr. MCINTYRE. That's correct.

MAINTAIN TAX BURDENS AT CURRENT LEVELS

Chairman HOLLINGS. Does that mean you maintain taxes at current levels?

That contemplates the fiscal drag of the present tax laws?

Mr. MCINTYRE. That's the point I was trying to make, the further point I was trying to make. What is implicit in that is a continuing increase in tax burdens. That, I think, goes back to Mr. Schultze's comments to Senator Exon a while ago, that at some point it is desirable to have a tax reduction because of the tax burden continuing to increase unless have a tax reduction.

Senator CHILES. Then the tax burdens actually enclose a fiscal drag. Your figures don't show the fiscal drag.

Chairman HOLLINGS. Do they show the fiscal drag?

Mr. MCINTYRE. Yes.

Chairman HOLLINGS. It does.

Mr. MCINTYRE. That is incorporated.

Chairman HOLLINGS. Even with the fiscal drag, you get the increases of a surplus, 1983 over1982, 1984 over 1983, and 1985 with a $106.8 billion surplus.

Mr. MCINTYRE. I think where your staff and my staff are both jumping around here is——

Chairman HOLLINGS. I don't see them jumping.

I am calm and happy and looking at you. [Laughter.]

IMPACT OF FISCAL DRAG ON ECONOMY NOT REFLECTED IN GNP

Mr. MCINTYRE. The difference in what we are saying, I think, Senator Chiles, is that the fiscal drag is certainly evident here and it is the impact the fiscal drag would have on the economy that is not reflected in the GNP figures.

Chairman HOLLINGS. Well, we might be saying the same thing, but in a different way.

Let me ask this: I was told the mistake we made was back in 1977 to 1979, because there is nothing that can be done to temper this high unemployment situation between now and the election. And very little can be done in calendar 1981, we still persist with an 8.5 percent-rate there—9 percent by some estimates, including CBO. Is it true, then, that if I am trying to make for a balanced budget in 1982 and 1983, is there something I should have done in 1980 or 1981?

I don't want to be accused of lethargy and indolence and no hope. Senator Domenici is in Detroit giving them hope. I want to be able to give them some hope. I don't want to be tardy with my hope.

Not—what do you call it, tricky or quickie?

Mr. SCHULTZE. I am sorry I used that word. [Laughter.]

Chairman HOLLINGS. The whole idea is hope. What hope can I give between now and November 4?

Mr. McIntyre, what hope will you give?

If I could carry Mr. Schultze around, I could get reelected. I don't mind that. [Laughter.]

I have a fellow who teaches golf. If I could get him to caddy for me, I could win the Masters. That's how I feel about Charlie Schultze. He can explain it all and it is happy and wonderful.

But you talk more our language. [Laughter.]

You talk what they call—slow Claghorne is what one of the reporters calls me. [Laughter.]

Mr. MCINTYRE. From my knowledge of your situation, you don't need anybody to carry around to help you. You are OK.

INSURE NEAR-TERM BALANCED BUDGET

Chairman HOLLINGS. Is there anything we should do now to insure that balanced budget, say, in 1982 or 1983?

Mr. MCINTYRE. I think, Mr. Chairman, that there are several elements of what we have to do if we are going to get everything under control to enable us to balance the budget in the near term.

CONTINUE POLICY OF FISCAL RESTRAINT

First of all, we have to continue our policy of fiscal restraint, in my judgment, in order to keep the lid on, and keep inflation going down, and deal with the problems of high interest rates.

I think that the action that we took jointly with the Congress in March has been successful and I don't think we ought to underestimate the success of that. Interest rates have come down dramatically. Inflation has come down dramatically. I think we will see a further dramatic decline in the inflation rate. I think the program was successful.

What we have to do is not to let this change in the economic situation drive us to abandoning this course of fiscal restraint. We have to keep at it and we have to make some inroads on some of these automatic or entitlement type programs in this budget in the future.

For right now, I think we should pursue the reconciliation process and continue to pursue a policy of fiscal restraint. That is absolutely important.

INVESTMENT INCENTIVES TO BUSINESS SECTOR

Second, I think we do have to take some steps. The all important thing is composition and timing here in my judgment. We do have to take some steps to provide investment incentives to our business sector so that we can improve productivity and create the jobs that are best created, frankly, in the private sector. We can drive down unemployment, have greater productivity, reduce the inflation rate, and get the economy moving rapidly again, and I think in those kinds of conditions we can have a balanced budget, Mr. Chairman.

BUSINESS SECTOR TAX CUTS ALONE UNACCEPTABLE

Chairman HOLLINGS. Could we be saying rather than quickie, it would be a long, drawn out proposition, especially if we are presented a tax bill at the present moment which only contain cuts for, say, the corporate tax rate, or investment credits or depreciation allowances, and not across the board to the individual which increases demand and inflationary pressures.

Politically, between now and November 4, you would have a difficult time because there would be that contingency within the Congress to say, oh, no, wait a minute. You can't give it all to business. You have to give some to the poor and some to the individual. Therefore, we really would be passing the wrong kind of tax cut, whereas, after the election, we may be able to withstand that and actually get a quickie.

We will be looking for it, a quickie, about February or March. Whereas, there is no way in the world to get it quick enough between now, if we started debating it this afternoon, and before November 4, without that substantial group within Congress saying: Oh, no, we are not going to that on November 4, not having done something for the individual.

Is that what we are saying?

PROVIDE TAX RELIEF TO INDIVIDUALS

Mr. MCINTYRE. I don't think we are saying it quite that way. I think there is some element of Christmas-treeing, frankly, involved, if you start running in the charged-up. atmosphere of a political year in which there is an election. But I think, Mr. Chairman, frankly, under any type of tax proposal you are going to make, that you are going to have to take into consideration the need to provide relief to the individuals in some fashion. That can be done in a variety of ways, not just simply an adjustment in rates.

Your suggestion that perhaps the Gephardt approach might be something that could be done is another way to provide relief to individuals. That also has the added advantage of giving some relief to business and could be seen—at least, in the long term prospective—as being anti-inflationary.

I think, while there is an element of Christmas-treeing that concerns us, our basic concern is that we need to develop a tax program that does the job and not one that simply satisfies the need to move rapidly and get something done in the last few days.

$100 BILLION APPROVED BUT UNUSED IN PUBLIC WORKS PROGRAMS

Chairman HOLLINGS. Don't let my questioning mislead you.

We have, as you well know, on the Democratic side a task force for a tax cut, to fashion one and present it by early September. I am not a member of that. Intentionally so.

I believe, as you have testified, we need to continue to lead the way for more restraint and not overstimulate the economy.

I haven't found a magic stimulus that could help us out of this unemployment momentarily. If we hold the line and hold the costs, I think it would be of tremendous value, giving stability to the entire business community, and, thereby, to productivity, and to the recovery.

Now, on the $100 billion found approved but unused in public works plans, at the end of June there was a study made both by a private entity, as I take it here, and a part of the Office of Management and Budget, and Pat Choate, an individual of the Federal Office of Management and Budget, said he agreed with the overall findings of the study made by this economist.

Incidentally, as an aside, I agree with you, also, Mr. McIntyre, and Senator Domenici, that we have meetings and have Senator Randolph and Senator Burdick and the others, and we disapproved—at least, those members who were there—a $2 billion public works stimulus program and we were unyielding on that. We were not going down the long road again.

Are you familiar at all with that report, the money amount in public works and community development block grant programs all backed up in the pipeline? I don't expect a detailed answer now.

Perhaps I could refer you to that article. I will get you a copy of it.[1]

Then you can see what we can do about it.

No. 1, we have to get better estimates and better communications. We can't jazz up $8 billion worth of spending in a 30-day period. We can't let Government spending, through delays, back up in the pipeline to the tune of $100 billion.

NO WAY TO SPEED UP GOVERNMENT WORK PROGRAMS

Mr. MCINTYRE. Mr. Chairman, I am familiar with the newspaper article with respect to Mr. Choate's study. Mr. Choate is not an OMB employee. He used to work for the Economic Development Administration. I know him.

I have asked my staff to check into this. I can get you a more detailed report on their findings. Basically, we are not aware of any way to speed up some of the work programs scattered throughout the Government—the Corps of Engineers, EDA, Appalachian Regional Commission. They are all over the Government.

Chairman HOLLINGS. Then do you think there's need to do it?

---

[1] See p. 260.

Mr. **McIntyre.** Well, for a number of these: Basically, the way we try to provide for these projects is to authorize them and then to provide for the spend down over a period of time. In some cases, we advocated fully funding these projects, such as in the Corps of Engineers.

I do think that, looking at it, there are only a couple of areas of that $100 billion where perhaps there could be some significant impact from an attempt to accelerate it. One would be in the Federal aid highway program, and another would be perhaps in some of the EPA construction funds.

But, in our joint effort in March, we specifically decided that perhaps we could defer some of these construction programs to help us meet our needs to reduce the budget.

I will get you a more detailed report on that.

Basically, we do not agree with the implications of this study that there is $100 billion sitting out there waiting to be spent, and we are dragging our feet on it.

INCREASE PROJECTED FOR MILITARY PAY COMPARABILITY

Chairman **Hollings.** That's interesting. I read where an official of the Federal Office of Management and Budget said he agreed with the overall finding. Any report you can give us on that would be appreciated.

With respect to the military pay increase, this CBO figure, rather than the previously used 11.7 percent to give pay comparability to our military, we find it now would require 12.6 percent and you use a 9.1-percent figure.

Why is there that difference?

Mr. **McIntyre.** I will have to check and see what CBO based their figure on. I would guess that what CBO has done is to actually take the overhang from last year's comparability and carry it forward into this year and add it to what the pay survey will indicate is required. I would be glad to check that out and give you a written statement as to the difference. Our figure represents the average figure for this year, what we call the PATC survey, which is a professional, administrative, technical and clerical survey we do every year. It has shown the average figure needed for comparability.

[The following was subsequently supplied for the record:]

CBO AND OMB PAY ASSUMPTIONS

Both CBO and the OMB use the results of the professional, administrative, technical and clerical (PATC) pay survey of the Bureau of Labor Statistics. That survey, which was recently completed, showed an average increase of 9.1 percent in the pay of those occupational categories and that is the amount that the administration recommends for military pay increases.

In addition to the increase that would be required to maintain comparability in the current year, the CBO also includes in its calculation an estimate of the increase that would be required to reach full pay comparability from the previous year. Thus, the current CBO pay comparability estimate includes not only the 9.1 percent PATC survey increase, but also that increment from the previous year.

The initial pay comparability figures were based on estimates made by the CBO and OMB before the PATC survey results were available. The increase from 11.7 percent to 12.6 percent in the CBO pay figure is, for example, due to a revised estimate based on more recent data and revised economic assumptions.

The basic difference, then between the CBO and OMB pay comparability estimates is the CBO's inclusion of pay catchup from the previous year.

Chairman **Hollings**. All right, are there any more questions?

10-5-3 THE ANSWER TO INDUSTRIALIZING STEEL COMPLEX

Senator **Chiles**. I am a little concerned that part of what we are talking about, and some of the tax cuts, I wonder whether they address the problems we have in trying to really do something about steel, autos, and heavy industries that everybody is saying we need to modernize.

Do you think 10-5-3 is going to be the answer to the industrializing of the steel complex?

Mr. **Schultze**. Not 10-5-3. I think it turns out that, when you liberalize depreciation, you particularly help industries that have a lot of capital and physical assets relative to what they turn out. I think there are a lot of problems with 10-5-3. Depreciation liberalization would particularly help the steel industry.

It wouldn't do much—at least, normally, not as much—for the auto industry. It varies from industry to industry. I don't know whether you want to pursue that further.

Senator **Chiles**. Of the plans noted, does the administration have some plan now on how to deal with these areas?

Can we afford to forgo the revenue we are going to forgo in some of the plans and still say we are going to be able to generate enough capital to take care of these problem sectors?

10-5-3 PLAN PROVIDES UNEVEN TAX BENEFITS TO DIFFERENT INDUSTRIES

Mr. **Schultze**. Let me make two comments in particular about 10-5-3.

First, the Treasury has estimated that, by the second half of the decade, it would be taking roughly half the corporate tax. That's a pretty heavy thing to do all of a sudden.

The second proposition is that what 10-5-3 does is classify everyone's assets, whatever they are, into three categories, a 10-year category, a 5-year category, and a 3-year category. What that does is give very uneven tax benefits to different industries depending upon the structure of their assets.

Let me give you the extremes. At one extreme, it would give a tax advantage to the gas utility industry that would be equal to 27 percent of its investments. For every dollar it invested, it would get with that bill a tax advantage equal to 27 cents.

On the other extreme, the construction industry would be getting 4 cents.

We have a range of 7 to 1 and no economic reason. Therefore, while my personal judgment is that although inflation has worked on depreciation in a way that is bad given the way we now handle depreciation, and that depreciation liberalization at the right time probably makes sense, but not to go about it that way has long-term consequences for the budget, and inflation I think, that are very bad, and internal structural problems that won't get at what you are getting at but may have random effects.

It will help some industries and not others, depending on a lot of peculiar characteristics. The administration has been looking at it and trying to figure out a way to do this to get some of the advantages on an equitable basis across industries, but without the disadvantages.

You have to compromise to do that. We are in the process of trying to do so.

OUTLAYS FOR SYNTHETIC FUEL MANDATE NOT REFLECTED IN BUDGET

Senator **DOMENICI**. Mr. McIntyre, the staff tells me that CBO has told us that it will cost $600 million in 1981 in outlays because of the synthetic fuel bill mandate on SPRO, the filling of SPRO. That's at that 100,000 barrel a day rate mandated in the bill. That $600 million from what we understand has not shown up in your Mid-Session Review.

Could you tell us—if not today, could you inform the committee—how the administration recommends that 100,000 barrels a day be paid for and how it should be reflected in the budget?

Mr. **MCINTYRE**. Yes, I can. I will be glad to do that.

It is not at all clear exactly how that cost will be handled because of the law that mandates the use of the entitlement program. We will be glad to get that information for you.

Chairman **HOLLINGS**. Before markup?

Mr. **MCINTYRE**. Yes.

[The following was subsequently submitted for the record:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

REC'D AUG 19 1980

AUG 19 1980

Honorable Ernest Hollings
Chairman, Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is to provide you with additional information which you requested on the Administration's budget estimates for the Strategic Petroleum Reserve (SPR).

The Administration is committed to an effective Strategic Petroleum Reserve and will comply with the requirements of the Energy Security Act of 1980 (ESA). The Act requires the President to resume SPR fill at a minimum average rate of 100,000 B/D for fiscal 1981 and succeeding years. The Act also requires the President to amend the crude oil entitlements regulations so as to achieve the effect of providing oil to SPR at the lower tier price. On August 4, 1980, the President signed an executive order delegating the necessary authorities to the Secretary of Energy to carry out these provisions.

The DOE will begin SPR fill by using the federal share of Naval Petroleum Reserves (NPR) production at Elk Hills, about 100,000 barrels per day (B/D) after allowance for the small refiner set aside. The President has signed the necessary authorization under the ESA allocating this oil to the SPR.

Most of the NPR oil cannot be placed directly in the SPR because of inadequate facilities for transporting the oil from the NPR production areas to SPR storage sites. Therefore, NPR oil will be exchanged for more accessible oil. The Defense Fuel Supply Center, the purchasing agent for DOE, issued a solicitation on August 11 for competitive bids for the exchange.

DOE also issued a notice of Proposed Rulemaking on August 8 for a regulated exchange of NPR oil. The regulatory approach will be implemented if the solicitation for competitive bids does not result in acceptable offers.

These actions alone should result in a fill rate which meets the requirements of the ESA. The Administration anticipates, however, a substantially higher fill rate in fiscal 1981, if current market conditions continue. The additional steps necessary to increase SPR fill rates will be taken after the initial actions to resume fill at the 100,000 B/D rate are successfully underway.

The OMB Mid-Session Review estimates, as indicated in the July 21 Report to the Congress, did not reflect either the Administration's recent actions to resume SPR fill or the requirements of the ESA. The Mid-session estimates were based on the acquisition plan in the March Budget, revised only to account for new oil prices.

Compliance with the ESA will result in total 1981 outlays for SPR of $1,560 million, an increase of $1,050 million above the March estimate. This estimate includes $1,300 million for oil acquisition and $260 million for facilities development. This level of outlays will assure the minimum level of oil acquisition required by the ESA in the event that the entitlements provisions of the ESA can not be carried out immediately. The estimate would also permit a higher rate of SPR fill if entitlements are taken into account. We believe that it is prudent to budget on this basis given the importance of the SPR fill program and the need to plan for a number of contingencies.

As I noted above, the Administration hopes to be in a position to achieve substantially higher fill rates. The outlay estimate we recommend would provide sufficient flexibility to do so, since the additional outlays would be substantially offset by the use of the entitlements program. Alternatively, the outlay estimate would allow us to maintain at least the statutory minimum fill rate in the event that problems arise in the implementation of the entitlements provisions. These problems include potential litigation, technical problems due to the effects of the Administration's decontrol program, and potential carryover in the collection of entitlements receipts into FY 1982, and we believe it is wise to take them into account.

Regarding the treatment of entitlements receipts, the Administration believes that these receipts should be considered as proprietary receipts, and thus offset the SPR outlays within the energy function. If the entitlements provisions are successfully implemented, receipts of up to $800 million may be realized in FY 1981.

The issue of budget authority for the SPR has received considerable attention, and we want to explain why we believe Congress should provide $2.4 billion for the program in FY 1981. This level provides $2.3 billion for oil acquisition and $0.1 billion for facilities development. The $2.3 billion in authority for oil purchases is needed in order to finance oil purchases in FY 1981 and to finance long term contracts for FY 1982. The $2.3 billion level is also necessary to provide flexibility to increase SPR fill rates if current favorable market conditions continue; to absorb any increased costs due to unexpected price increases; and to compensate, if necessary, for potential technical or legal problems in the implementation of the entitlements program.

The problem of forward funding is critical, especially so at increased fill rates. DOE intends to execute 1-year contracts for the oil which it acquires in exchange for NPR oil. For any other oil, DOE will execute contracts for at least six months and possibly longer. Therefore, the 1981 BA level needs to provide sufficient funds for all oil deliveries in FY 1981 and some or all deliveries in FY 1982. Unless Congress provides $2.3 billion in FY 1981 for the program, it could be seriously constrained by lack of funding.

For example, I would note that, even with a 100,000 B/D fill rate in FY 1981, the SPR program would have to obligate a minimum of $2.9 billion in FY 1981 in order to meet the FY 1982 fill program in the President's budget if all procurements were made on the basis of 1-year contracts. In order to do this, the SPR program would have to use all potential entitlements receipts, and in addition it would need funding of at least $2.1 billion in FY 1981. Unexpected price increases would increase the needed funding. DOE is also considering a number of other oil acquisition plans, and those plans would also require complete utilization of $2.3 billion budget authority in FY 1981. Failure to take these factors into account now could jeopardize the implementation of the SPR program, including the requirements of the Energy Security Act.

The Administration does not believe it is desirable or feasible to establish fixed SPR fill targets at this time. Fill rates cannot be predicted with any degree of accuracy, as events of the past few years have so clearly demonstrated. It is essential, however, that DOE have the flexibility to acquire oil when opportunities arise. In view of the substantial adverse consequences to the U.S. of a major supply disruption, an opportunity to fill SPR should not be lost because of inadequate budget authority.

I hope that this additional information fully responds to your concerns. If I can be of additional assistance on this or other matters, please let me know.

Sincerely,

Jim McIntyre

James T. McIntyre, Jr.
Director

EXTEND TAX CUT PACKAGE OVER 5-YEAR PERIOD

Senator **Domenici**. Mr. Schultze, while Arthur Burns most recently tends to agree that we ought not to act hastily with a tax cut, my understanding of his reasoning—maybe I misread you—seems to be the opposite of yours.

He seems to think that what we need really is a 5-year tax package with cuts increasing in each of the 5 years, maybe starting out with a small personal and small business, and then the business end growing, and the personal end growing, too, but with the business tax growing more in the outyears.

Did I understand that you thought that was the long way to go?

Mr. **Schultze**. Well, first, I don't think I ever said that. I am trying to get my answer correct.

I don't have any philosophical or fundamental economic reason for wanting to schedule tax cuts in advance, but it is very critical whether, over a 5-year period, this staged tax cut loses you $75 billion or $280 billion, so I don't think that there is any particular reason why I would disagree with Dr. Burns.

Before I made up my mind, I would want to very seriously wonder how much I want to give my flexibility away in the future.

First, I would say that maybe one should not throw away the idea of a staged tax cut arbitrarily as bad, but I would sure want to know how big the stages were and to be very careful in the outyears.

Finally, having gone through all that, I would want to sit down and say maybe for 2 years, but let's not commit ourselves to 5 years. We don't know what the world will look like. Will there be another Afghanistan?

I don't know. I would just as soon not go that far with five stages.

Two stages, maybe. So I am waffling, I realize.

PRODUCTIVITY ORIENTED TAX CUT

Senator **Domenici**. It does seem to me there is some merit to his proposal. It seems that what is really happening, with all our good intentions—and we fell into it, I believe—the tax ratio versus productivity is too high. Almost everyone admits that. Almost everyone admits that productivity oriented taxes have to be the order of the day, whether it is next month or in March. Everyone says that has to happen.

It seems to me we continue to hold that kind of program hostage to this hope, and the hope is a good one, that we will cut a deficit, that we curtail inflation, and we might get a balanced budget.

If I read Arthur Burns right, he is saying stay on your fiscal restraint policy. Don't bust that too much by a big tax cut this year. But go ahead and acknowledge that you cannot hold that kind of broad tax cut hostage any longer. You better build it in and adjust your spending thereafter.

Whether that creates deficits in the third year of that reform package or not, you still have built into that economy one of the basic ingredients of not taking too much out of it and targeting it in terms of taxation. That is how I read him.

Mr. **Schultze**. I think I would read him the same way.

I was up in Canada a couple of weeks ago where they have indexed the tax system. This is one way of having your tax cut stretched out to the future.

Senator DOMENICI. I don't think he recommends that.

Mr. SCHULTZE. I understand. The point I want to make is that we were discussing the business about having a productivity oriented tax cut.

I was suggesting there is no question in the years ahead that that is what the United States will have to do to hold down Government spending and take some of those resources that go into Government and put it into investment through business oriented tax cuts.

He said: Gee, I wish we could do that.

I said: Why can't you?

He said: We have already indexed the tax system, so we can't take advantage of doing this.

I don't know what our needs will be 3 or 4 years from now. Maybe you don't mind having a two-stage giveaway for 2 years in a row, but even for the best of purposes I am not sure I want to lock myself in for 5 or 6 years in a row. Maybe we will have a different need 4 years from now. It is hard to tell. We are not that smart.

Senator DOMENICI. What if, in the last 3 years, we have these deficits and we had an ongoing policy of tax cuts in every one of those years of the type that you think would be most appropriate to cope with productivity and incentives? Do you think we would be worse off if we had a $20 billion tax cut each of the last 2 years?

Isn't it possible we might be better off even in terms of deficit, even in terms of inflation, even in terms of GNP?

Mr. SCHULTZE. It is highly unlikely.

We did have a $25 billion tax cut in 1979.

Senator DOMENICI. The biggest aspect of it in terms of productivity was capital gains, as I remember.

Mr. SCHULTZE. And there was some corporate rate cut.

A large proportion of the tax cut went for business, one way or the other. Larger than is normal.

Chairman HOLLINGS. Small business, too.

Mr. SCHULTZE. Yes. We didn't do all that badly.

The one time we probably wouldn't have wanted this is in a year in which we got stuck with the big inflationary surge because of OPEC. We have to hold things down to keep that from spreading; 1979 was a year when we probably wouldn't have wanted it. I am not sure we would have been better off. I think we would have been much worse off, to tell the truth, in this particular instance. Maybe in some other period of history we would have been better off. Not this period.

ASSESSING THE WELL-BEING OF U.S. INDUSTRIES

Chairman HOLLINGS. You have been very considerate and very helpful, Mr. Schultze.

On the matter of the automobile industry, is the unemployment so singular that it is rather difficult to address in the sense that that is where it all permeates?

Automobiles right into steel, and rubber, or, even the textiles, they have been laying off people in South Carolina where they have been making profits for the automobile industry, that kind of thing.

Let me ask, in the reverse from Senator Chiles, about the American industry being sick. Do we have any other sick industries other than automobiles and steel?

Isn't industry rather healthy? The market is up. They are all building. In fact, they had at the beginning of this year, all kinds of plans which they had to cancel on account of the recession.

But investment, productivity, and everything else was going great.

Am I wrong?

Is American industry sick? Where is it right now? What other industries other than automobiles and steel are sick, that you know of?

Mr. SCHULTZE. Can I spend 20 seconds getting to the answer?

Chairman HOLLINGS. Sure.

AMERICAN INDUSTRY GENERALLY HEALTHY

Mr. SCHULTZE. We are in a recession. You ought to ask yourself: Do you have sick industry? Do you have industries that, even apart from the recession, have troubles?

A lot of industry has trouble because they are in a recession but that is basically short lived. It will be. We will do things, and it will be better. Do any have longer lived problems? There are a few.

Basically, I agree with you. People tend to overstate the sickness. The auto industry, even if you didn't have a recession, has the problem of making a transition from big cars to small cars, and that would have taken time. They couldn't do it right away.

They would have lost some sales. Even without a recession, the auto industry would have had problems.

This holds true all over the world. Even in periods of nonrecession, the steel industry in most places has problems. Europe, they have way over capacity. Real problems. There are a couple of others. For example, railroads. Not all railroads but some railroads have been in trouble for a long time. It may very well be that part of the shipping industry has a longer term problem because the declining quantity of oil means a lot less business for oil tankers. Those are important problems.

American industry generally is not sick. The numbers I showed in my testimony, table 3,[1] indicate we have done a darn good job in increasing industrial production. We have a recession, which means a lot of industry has had temporary problems. A few industries have longer term problems. Most of those, I think we will lick them. I think the auto industry will lick this. It will take time.

Chairman HOLLINGS. Alan Greenspan, yesterday, was talking along the same lines. He is an advisor to several of the U.S. steel companies. He said the industry was not homogenous. It had bright spots and would be recovering. He wasn't opposing a tax cut but any kind of tax plan for its own recovery, and he thought automobiles were coming back.

Specifically, he was not supporting necessarily an RFC.

---

[1] See p. 157.

Our friend, Felix Rohatyn, keeps writing every day he will save New York. He will save American industry.

You don't support that, do you? You don't want an RFC to reindustrialize—you see, we politicians have to discover something new. There is no civil rights bill to pass. Unless you can think up a new one——

Mr. SCHULTZE. It may be a great idea. It just needs a problem to be applied to. People are looking for a problem to apply it to. [Laughter.]

Chairman HOLLINGS. That's right.

Anything further?

On behalf of the committee, let me thank you both very much. We appreciate it.

[Whereupon, at 4:41 p.m., the hearing was concluded.]

ECONOMIC BACKGROUND FOR THE SECOND CONCURRENT RESOLUTION FOR FISCAL YEAR 1981

THURSDAY, JULY 24, 1980

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m. in room 6202, Dirksen Senate Office Building, Hon. Ernest F. Hollings (chairman of the committee) presiding.

Present: Senators Hollings, Chiles, Metzenbaum, Bellmon, Domenici, and Boschwitz.

Staff present: John T. McEvoy, staff director; Susan J. Lepper, chief economist.

For the minority, Robert S. Boyd, staff director; Gail D. Shelp, senior economist.

OPENING STATEMENT OF CHAIRMAN HOLLINGS

Chairman HOLLINGS. We are pleased to welcome today Chairman Volcker of the Federal Reserve. Chairman Volcker, we know that you have had an arduous hearing schedule this week and we appreciate your willingness to be with us today to accommodate our very tight schedule of preparations for the second and binding concurrent resolution on the budget for fiscal year 1981.

The current economic situation is very disturbing. After rising sharply, interest rates have come down sharply—but the economy has come down with them. This is, we are told, pulling the plug on our careful plans for a balanced budget.

Last spring when you appeared before this committee you urged spending restraint so that Federal borrowing would "get out of the way" of private borrowing and interest rates could come down. We have tried to achieve budget restraint and we will be very interested in your views of how the Federal Reserve will respond. We know that the Federal Reserve has a hard job in trying to curb inflation and speculation and to protect the dollar. We want to work with you in achieving these objectives while allowing for a healthy expansion in the economy. We will appreciate your suggestions on how we can achieve these objectives together.

After opening statements by my colleagues, we would appreciate any summary statement you may wish to make. A longer written statement can be put in the record, if you wish. We will then proceed with questions.

RESPONSE OF FEDERAL RESERVE TO RISING INFLATION TOO VIGOROUS

While waiting for some of my colleagues, in the meantime I want to ask you a few questions. As I indicated, we are trying to find a blame for this precipitous change, and we figured you might be the person to jump on. CBO wouldn't agree with it, nor would Dr. Greenspan or Dr. Heller.

The thought was that perhaps everybody had predicted a recession and it never did show up, so finally the economists, in order to save face, persuaded you to cause one immediately. [Laughter.] And that you acted, in essence, entirely too vigorously. What would be your comment about that?

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **Volcker**. I can't object to the comments that you report from others that we're not to blame.

I think, Senator, we were caught—and still are, in a sense—in a no win situation, once this inflationary momentum and inflationary expectation really got going. Inflation, of course, has been going on for at least 15 years. I'm not sure how much it really affected people's behavior and expectations until recently.

One of the things holding up business in the face of all of those predictions of recession last year is the fact that people expected inflation; they expected inflation to be getting worse. So consumers went more heavily into debt. They had an exceptionally high level of spending relative to income, and fooled all the economists. The reflection of that was in a very low savings rate, the lowest savings rate we have seen except in the Great Depression. All those things are ultimately unsustainable but the question was when would it break.

CREDIT DEMANDS AND BEHAVIOR AFFECTED BY INFLATIONARY EXPECTATIONS

In the early part of the year we were faced with a situation where for a variety of reasons the inflationary pressures, and particularly the inflationary expectations, were accelerating further. You will recall all the fears that the Consumer Price Index and Producer Price Index coming out in the 15- to 20-percent range represented a new level of inflation, and that inflation would continue at that level or move higher. That was affecting credit demands and behavior.

So you have a simple choice. We could have said, "We've got some worries about recession, and we can let this process go on because we don't want higher interest rates, and we will create some more money and try to keep it going." I think the result of that would have been to enhance those expectations—to, in fact, make them come true—and ultimately we would have had a recession anyway because it was just unsustainable.

We felt we had to act against that situation, and we did. The economy turned around pretty fast—not just for that reason. It was ready to turn, apparently, in hindsight. Looking backward it's very easy to say we didn't need to do it, but I don't think that's right. We would have had those expectations exploding on us, and we would have had a less satisfactory situation ultimately. I think this easy reading of history, of "overkill" or whatever the phrase is, reflects a lack of appreciation that once you let the economy get in that situation, you haven't got an answer, a satisfactory answer.

Our policy has to be to avoid getting in that situation in the future.

Chairman HOLLINGS. How can we do that?

ASSESS EFFECT OF SHORT-RUN ACTIONS ON LONG-TERM PROBLEMS

Mr. VOLCKER. That is the whole question that I try to deal with in the statement I distributed to the committee.[1] In conceptual terms, first of all, I would say any overt action we take in the short run to deal with the situation as we see it—the fact that we are in a recession, as well as in inflation—must be not just toward the impact in the next few months and for recovery from now until the end of the year and 1981, but toward working against the longer term problems that are so evident.

What are the longer term problems? Productivity related to growth and real income. Our performance has been abysmal for a decade. If we don't deal with that, then we're going to have continuing troubles.

We have, of course, the energy situation. If we leave ourselves and other Western countries leave themselves vulnerable to such a heavy demand for energy, we're never sure when those prices are going to go up and upset the applecart.

We have a lot of inflationary psychology, a lot of inflationary momentum built into the economy which is reflected in wage movements in particular. What can we do to change that trend—which I think will change—to speed the change and trend in that area most rapidly?

In the area of monetary policy, close to home, I believe we have no alternative but to work overtime toward a rate of growth of money consistent with price stability. We have been moving in that direction gradually.

That is our intention. I think there is wide support in the Congress to that approach, and certainly in the Banking Committees to which we report. I think it's rather broadly understood around the country, despite confusion in the short run. I think the intent and the necessity of that effort is understood.

We are moving in that direction, but when everything else is moving in a direction to expand costs and to increase inflation, then you have a problem. We are moving in one direction and the rest of the world is moving in the other direction; the economy isn't going to perform very satisfactory.

BUDGET PROCESS MAJOR INSTRUMENT IN RECONCILING ECONOMIC GOALS

A major instrument that is obviously in the hands of the Government is the budgetary instrument for reconciling these goals. It seems to me if we are going to work, for instance, on the productivity side and on the cost side, and if we have in tax policy an instrument that is adaptable to that purpose, it should be adapted to that purpose. We have to have on the spending side of the budget a situation that makes it feasible to move in that direction. Unfortunately, I don't think we have that situation at the moment.

---

[1] See p. 216.

Chairman **Hollings**. On the budget side?

Mr. **Volcker**. On the spending side of the budget, yes.

ANALYSIS OF THE FIRST CONCURRENT RESOLUTION

Chairman **Hollings**. Let's look into that in a little bit more detail. The budget that we adopted in the first concurrent resolution, what would be your comment on it and why isn't that an appropriate budget? It wasn't restrictive enough?

Mr. **Volcker**. My impression is that that first concurrent budget resolution which the committee and the Congress developed under the pressure of events in the spring, with considerable effort on the part of the administration as well as the Congress, represented a considerable contribution to moving in the direction that's necessary.

What concerns me is not that resolution but what seems to be happening since the resolution. We have had some history of that in the past, as you well know, where the results turn out to be somewhat different from the resolution. Fiscal 1980 is a classic example. I don't remember the original budget resolution in that connection on the spending side, but if I recall the figure correctly, that budget is up something like 18 percent now; it was nothing like that in the original resolution.

Now we have a situation where the budget resolution was developed in late winter and early spring, and here we are in July we have an outlay level that is about $30 billion above, according to the administration's estimate in March.

To an extent, a significant part of that change is simply a reflection of the recession—higher unemployment, benefits and other factors. I would put those spending increases aside, so to speak, in analyzing the basic budget. But not all of that increase is related to the recession. I'll understate the case: the trend is not as comforting in that respect as one would like to see if you're going to seriously talk about substantial tax reductions.

BASIC BUDGET FOR 1981 ERODED BY UNPREDICTABLE CIRCUMSTANCES

Chairman **Hollings**. On the resolution itself, not necessarily defending it, but the 1980 deficit boiled down to that level around $29 billion—in fact, we fought for hours to get it just below $30 billion. That was sort of the target for 1980, a $29.9 billion deficit. And with 1981, we thought we had it in balance.

Now, what occurred wasn't necessarily a change in the spending legislation, or a change in the resolution itself, but rather, a change in circumstances in 1980. You have Afghanistan and the precipitous recession, causing a drop in revenues of $8 billion right there. You have accelerated spending in defense and payouts for farm price supports, disaster loans, assistance and everything else of that kind, another $8 billion. That was $16 billion just this last 2 or 3 weeks.

Looking at 1981, as I say, if unemployment averages 7.5 percent rather than now the projected 8.5 percent, we will still be in balance.

Go ahead. I want to get your comment on the 1981 budget.

Mr. VOLCKER. I would——

CUT SPENDING AND MAINTAIN BALANCED BUDGET

Chairman HOLLINGS. You see, this is what we're looking at. The committee is going back into session in markup and we're going to try our best to either hold the line on the first concurrent resolution and make those necessary adjustments and so forth in social security, accelerated defense spending, whatever it is. You can't subtract it. It's done.

But from the Fed's standpoint, what should be done about that 1981 budget? Do you think we ought to cut back even further on that spending and try to still maintain a balanced budget?

Mr. VOLCKER. Let me comment again on the effects of the recession. I would discount, on the revenue side, as well as on the expenditure side, the more or less automatic reactions to the recession; the economic assumptions have changed, and that's responsible for the swing in the deficit. I don't think that has the same significance as other things, particularly the spending trend.

But my impression is that both the 1980 and 1981 budgets have been affected by changes other than changes in the economic assumptions. A major element is the defense program, and that raises a major question, obviously, of public policy. I'm not sure I know the full significance of why defense spending is running as much higher at the moment only a few months after the estimate in the budget; there may be some temporary factors at work.

TAX REDUCTIONS

But one of the problems facing this 1981 budget and beyond, to put it in the context of the tax reduction discussion, is that people are talking about a permanent reduction in taxes, something that's going to continue and, in fact, increase over the years. A major question is what's going to happen to the defense part of the budget. If that is going to increase at the recent rate of speed—and I'm not arguing now whether that's good or bad; that's a question of the appropriate security posture—and if it is going to result in substantial increases in expenditures, and cuts can't be made elsewhere, it bears upon the prospects for tax reductions.

BUDGET NOT IN INVITING POSITION FOR SIZEABLE TAX CUT

I assume this committee, which has done yeoman service in making the budget process both more orderly and more effective, is going to be looking very hard at that. The question is, are there cuts to be made elsewhere in the budget? Your immediate problem is fiscal 1981 and your degree of flexibility is probably quite limited. What's going to happen beyond fiscal 1981.

I do conclude that on the basis of the budget figure I see now—and, of course, the administration's revenue estimates include at least one tax increase that hasn't been passed, the gasoline tax increase—the budget is not in an inviting position for a sizable tax reduction in my opinion.

Chairman HOLLINGS. You say it's in a position for a sizable tax——

Mr. VOLCKER. It is not; it's not.

Chairman HOLLINGS. There is a great deal of emphasis by all of us on the timing. When you say the budget is not in a position, you're talking about the 1981 budget?

Mr. VOLCKER. I'm talking about 1981, yes.

PRE-ELECTION TAX CUT UNWISE

Chairman HOLLINGS. Just for the moment, consider this as Congressmen and Senators here during the next few months. Let's say before the election, am I to understand that it wouldn't be wise to start passing a tax cut?

Mr. VOLCKER. I think that would be unwise, yes, because I cannot see the conditions in place that make that a prudent action at this time. We have now an estimate of a $60 billion or so deficit for this year; we have an estimate of a deficit for next year in the neighborhood of $30 billion, without a tax cut.

Chairman HOLLINGS. Right.

Mr. VOLCKER. I have two concerns. What happens, to the revenue lost in the tax cut itself? I don't feel confident, if I can put it that way, at this stage—maybe I would feel confident later in the year after you finish your actions—that the current spending level estimated by the administration is necessarily it; the momentum seems to be in the direction of increases.

Chairman HOLLINGS. So the first real concern of the Fed is this momentum, and the best indications that we can give, or any indications that we can give that we have arrested the momentum or held it down, or have shown restraint, and still work, let's say, for that balanced budget would be a salutary approach as you see it; but on the contrary, if instead we started providing for tax cuts it wouldn't give any indication that we were slowing that momentum. Is that what you're saying?

Mr. VOLCKER. Yes. I would put the emphasis more on the outlay side than on the deficit, per se, because those numbers will be affected by the economic assumptions.

The spending number and the spending trend seem to me to be the crucial factor here. Even if we had enormous assurance that the current level of outlay could be maintained, you have still got a doubtful proposition, a question of how much room there is. There are other factors that enter into the question of tax reduction.

But I think it is safe to say, the more that trend is not arrested, the more the momentum continues, the more the case is eroded.

Chairman HOLLINGS. Well, good. I apologize for the committee. We've got a respectable audience now. The reason is that we have been pressed all week. We have just got back and the Senators haven't caught up with their mail. They got into Alaska lands. And while everybody is talking tax cuts, last night we passed a tax increase of $4.2 billion. We're just catching up to prepare ourselves in trying to mark up a second concurrent resolution.

Perhaps with the other Members here now you would want to include your statement in its entirety in the record, along with the

Midyear Monetary Policy Report to Congress,[1] so that we'll have it all there. Then you can highlight it, Mr. Chairman, as you wish.

Mr. Volcker. I will not read the statement, Mr. Chairman. This is a statement that I prepared for the Banking Committees, it is the midyear monetary policy report. I think it is directly relevant to the questions you're concerned with in the Budget Committees.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 23, 1980

MEMORANDUM FOR MEMBERS OF THE SENATE BUDGET COMMITTEE

Attached is a statement that was prepared in connection with the presentation to the Congress of the Federal Reserve Board's semi-annual report on monetary policy. It is relevant to our planned discussion on Thursday, July 24, and I thought it would be of interest to Committee members. I do not plan any additional written statement but am prepared to respond to your questions.

Paul A Volcker

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

on Monetary and Related Policies

I am pleased to be here today to review the conduct of monetary policy and to report on the Federal Reserve's economic objectives for the year as a whole, as well as its tentative thinking on policy goals for 1981. Our so-called "Humphrey-Hawkins Report" has already been distributed to you. I would like simply to add some personal perspective this morning on the course of monetary policy, in the context of the economic prospects and choices facing us with respect to other policy instruments.

Seldom has the direction of economic activity changed so swiftly as in recent months. Today the country is faced simultaneously with acute problems of recession and inflation. There have been unprecedented changes in interest rates and the imposition and removal of extraordinary measures of credit restraint. The fiscal position of the Federal Government is changing rapidly.

In these circumstances, confusion and uncertainty can arise about our goals and policies, not just those of the Federal Reserve, but of economic policy generally. Therefore, I particularly welcome this opportunity to emphasize the underlying continuity in our approach in the Federal Reserve and its relationship to other economic policies, matters that are critical to public understanding and expectations.

The Federal Reserve has been, and will continue to be, guided by the need to maintain financial discipline -- a discipline concretely reflected in reduced growth over time of the monetary and credit aggregates -- as part of the process of restoring price stability. As I see it, this continuing effort reflects not simply a concern about the need for greater monetary and price stability for its own sake -- critical as that is. The experience of the 1970's strongly suggests that the inflationary process undercuts efforts to achieve and maintain other goals, expressed in the Humphrey-Hawkins Act, of growth and employment.

As you know, our operating techniques since last October have placed more emphasis on maintaining reserve growth consistent with targeted ranges for the various Ms, with the implication interest rates might move over a wider range. Those targets were reduced this year as one step toward achieving monetary growth consistent with greater price stability. For several months after the new techniques were introduced in October, the various aggregates were remarkably close to the targeted ranges.

At that time, and for months earlier, you will recall widespread anticipations of recession. Nevertheless, reflecting a variety of developments at home and abroad -- including an enormou new increase in oil prices, Middle-Eastern political volatility, and interpretations of adverse budgetary developments -- there was a marked surge in the most widely disseminated price indices and in inflationary expectations in the early part of this year. Those expectations in the short run probably helped to support business activity for a time; in particular, consumer spending relative to income remained very high, with the consequence of historically (and fundamentally unhealthy) low savings rates and high debt ratios. Speculation was rife in commodity markets.

Spending and speculative activities of that kind are ultimately unsustainable. But they carried the clear threat of feeding upon themselves for a time, contributing among other things to a further acceleration of wage rates and prices. In that way, inflation threatened to escalate still further in a kind of self-fulfilling prophecy, posing the clear risk that the subsequent economic adjustment would be still more difficult.

Credit markets reflected these developments and attitudes. Bond prices fell precipitously. Long-term money -- including mortgages -- became difficult to raise. Partly as a consequence, short-term demands for credit ballooned in the face of sharply rising interest rates, at the expense in some instances of further weakening business balance sheets. That heavy borrowing also was reflected in acceleration in the money and credit aggregates during the winter.

An attempt to stabilize interest rates by the provision of large amounts of bank reserves through open market operations to support even more rapid growth in money would probably have been doomed to futility even in the short-run, for it could only have fed the expectations of more inflation. It would certainly have been counter-productive in terms of the overriding long-term need to combat inflation and inflationary anticipations. Instead, consistent with our basic policy approaches and techniques, the

Federal Reserve resisted accommodating the excessive money and credit growth.

During this period of rising inflation and interest rates, the Administration and the Congress also appropriately and intensively reviewed their own budget planning. Coordinated with the announcement of the results of that broad governmental effort and the decision of the President to invoke the Credit Control Act of 1969, the Federal Reserve announced on March 14 a series of exceptional, temporary measures to restrain credit growth, reinforcing and supplementing our more traditional and basic instruments of policy.

The demand for money and credit dropped abruptly in subsequent weeks, reflecting the combined cumulative effects of the tightening of market conditions, the announcement of the new actions, and the rather sudden weakening of economic activity. In response, interest rates within a few weeks fell about as fast -- in some instances faster and further -- than they had risen in earlier months. Growth in the aggregates slowed, and for some weeks M-1A and M-1B turned sharply negative.

There is no doubt in my mind that these lower levels of interest rates can play a constructive role in the process of restoring a better economic equilibrium and fostering recovery. Indeed, there is already evidence -- if still tentative -- that homebuilding and other sectors of the economy sensitive to credit costs and availability are benefitting. Meanwhile, progress is being made toward reducing consumer indebtedness relative to income and toward restructuring corporate balance sheets as bond financing has resumed at a very high level. The sharp improvement in credit market conditions has been accompanied by slower rates of increase in consumer and producer prices, helping to quiet earlier fears of many of an explosive increase in inflation.

The suddenness of the change in market conditions has, however, raised questions in some minds as to whether the interest rate declines were in some manner "contrived" or "forced" by the Federal Reserve -- whether, to put it bluntly, the performance of the markets (together with the phased removal of the special credit restraints) reflects some weakening of our basic commitment to disciplined monetary policy and the priority of the fight on inflation. These perceptions are not irrelevant, for they could affect both expectations and behavior, most immediately in the financial and foreign exchange markets, but also among businessmen and consumers.

The facts seem to me quite otherwise.

Growth in money and credit since March has certainly not exceeded our targets; the M-1 measures have in fact been running below our target ranges. Bank credit has declined in recent months; while the decline in commercial loans of banks can be explained in part by exceptionally heavy bond and commercial paper issuance by corporations, there is simply no evidence of excessive rates of credit expansion currently. In these circumstances, it is apparent that interest rates have responded -- and have been permitted to respond -- not to any profligate and potentially inflationary increase in the supply of money, but to changes in credit demands, and (so far as long-term interest rates are concerned) to reduced inflationary expectations.

It is in that context -- with credit demands reduced and growth of credit running well within our expectations and targets -- that the special credit restraint programs simply served no further purpose. Those measures were invoked to achieve greater assurance that credit growth would in fact slow, and that appropriate caution would be observed in credit usage. The special restraints are inevitably cumbersome and arbitrary in specific application. They involve the kind of intrustion into private decision-making and competitive markets that should not be part of the continuing armory of monetary policy; their use was justified only by highly exceptional circumstances -- circumstances that no longer exist. Our normal and traditional tools of control (which in fact have been solidified by the Monetary Control Act passed earlier this year) are intact and fully adequate to deal with foreseeable needs.

Neither the decline in interest rates nor the removal of the special restraints should be interpreted as an invitation to consumers or businessmen to undertake incautious or imprudent borrowing commitments, or as lack of concern should excessive growth in money or credit reappear. That is not happening now.

But markets (and the public at large) remain understandably extremely sensitive to developments that might aggravate inflationary forces. As we saw only a few months ago, consumers and businessmen will react quickly in their lending and borrowing behavior to that threat.

While the recent easing of financial pressures helps provide an environment conducive to growth, we should not be misled. A resurgence of inflationary pressures, or policies that would seem to lead to that result, would not be consistent with maintenance of present -- much less lower -- interest rates, receptive bond markets, and improving mortgage availability. We in the Federal Reserve believe the kind of commitment we have made to reduce monetary growth over time is a key element in providing assurance that the inflationary process will be wound down.

I noted earlier the money stock actually dropped sharply during the early spring. In a technical sense, working on the supply side, we provided substantial reserves through open market operations during that period, but commercial banks, finding demands for credit and interest rates dropping rapidly, repaid discount window borrowings as their reserve needs diminished. In general terms, it seems clear that, at least for a time, the demand for money subsided (much more than can be explained on the basis of established relationships to business activity and interest rates) apparently because consumers and others hastened debt repayment at the expense of cash balances and because the earlier interest rate peaks had induced individuals to draw on cash to place the funds in investment outlets available in the market.

As the Report illustrates, M-1 growth has clearly resumed, and the broader aggregate M-2 is now at or above the mid-point of its range. In the judgment of the Federal Open Market Committee, forcing reserves on to the market in recent weeks simply to achieve the fastest possible return to, say, the mid-point of the M-1 ranges may well have required early reversal of that approach, have been inconsistent with the close-to-target performance of the broader aggregates, and therefore led to unwarranted interpretations and confusion about our continuing objectives. Depending on the performance of the broader aggregates and our continuing analysis of general economic developments, the FOMC is in fact prepared to contemplate that M-1 measures may fall significantly short of the mid-point of their specified ranges for the year.

I have emphasized the Committee's intention to work toward the lower levels of monetary expansion over time. In reviewing the situation this month, the Committee felt that, on balance, it would be unwise to translate that intention into specific numerical targets for 1981 for the various Ms at this time. That view was strongly reinforced by certain important technical uncertainties related to the introduction of NOW accounts nationwide next January, as well as by the need to assess whether the apparent shift in demand for cash in the spring persists.

At the same time, the general nature of the potential problems and dilemmas for 1981 and beyond is clear enough; these are important questions, not just for monetary policy but for the full armory of public policy.

The targets for the monetary aggregates are designed to be consistent with, and to encourage, progress toward price stability without stifling sustainable growth. But in the short-run, the demand for money (at any given level of interest rates) tends to be related not to prices or real output alone, but to the combined effects of both -- the nominal GNP. If recovery and expansion are accompanied by inflation at current rates or higher, pressures on interest rates could develop to the point that consistency of strong economic expansion with reduced monetary growth would be questionable.

Obviously, a satisfactory answer cannot lie in the direction of indefinitely continued high levels of unemployment and poor economic performance. But ratifying strong price pressures by increases in the money supply offer no solution; that approach could only prolong and intensify the inflationary process -- and in the end undermine the expansion. The insidious pattern of rising rates of inflation and unemployment in succeeding cycles needs to be broken; with today's markets so much more sensitized to the dangers of inflation, economic performance would likely be still less satisfactory if that pattern emerges again. The only satisfactory approach must lie in a different direction -- a credible effort to reduce inflation further in the period ahead, and policies that hold out the clear prospect of further gains over time, even as recovery takes hold.

We are now in the process of seeing the inflation rate, as recorded in the consumer and producer price indices, drop to or even below what can be thought of as the underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity. We can take some satisfaction in the observed drop of inflation, and the damping of inflationary expectations. But the hardest part of this job lies ahead, for we now need to make progress in improving productivity or reducing underlying cost and wage trends -- as a practical matter both -- to sustain the progress.

The larger the productivity gain, the smoother will be the road to price stability -- partly because that is the only way of achieving and sustaining growth in real incomes needed to satisfy the aspirations of workers. Put in that light, the importance of a concerted set of policies to reconcile our goals -- not simply relying on monetary policy alone -- is apparent. While those other policies clearly extend beyond the purview of the Federal Reserve, they obviously will bear upon the performance of financial markets and the economy as the Federal Reserve moves toward reducing over time the rate of growth in money and credit.

In that connection, I recognize the strong conceptual case that can be made for action to reduce taxes. Federal taxes already account for an historically large proportion of income. With inflation steadily pushing income tax payers into higher brackets and with another large payroll tax increase to finance social security scheduled for 1981, the ratio will go higher still. The thesis that this overall tax burden -- and the way our tax structure impinges on savings and investment, costs and incentives -- damages growth and productivity seems to me valid. Moreover, depending on levels of spending and the business outlook next year, the point can be made that the implicit and explicit tax increases in store for next year will drain too much purchasing power from the economy, unduly affecting prospects for recovery.

But I must also emphasize there are potentially adverse consequences that cannot be escaped -- to ignore them would be to jeopardize any benefits from tax reduction, and risk further damage to the economy.

Whatever the favorable effects of tax reduction on incentives for production and productivity over time, the more immediate consequences for the size of the Federal deficit, and potentially for interest rates and for sectors of the economy sensitively dependent on credit markets, need to be considered.

Many of the most beneficial effects of a tax reduction depend upon a conviction that it will have some permanence, which in turn raises questions of an adequate commitment to complementary spending policies and appropriate timing. We are not dealing with a notion of a "quick fix" over the next few months for a recession of uncertain duration, but of tax action for 1981 and beyond at a time when Federal spending levels, even for fiscal 1981, appear to be a matter of considerable uncertainty, with the direction of movement higher.

Experience is replete with examples of stimulation, undertaken with the best motives in the world, that has turned out in retrospect to have been ill-timed and excessive. Given the demonstrable frailty of our economic forecasting, it takes a brave man indeed to project with confidence the precise nature of the budgetary and economic situation that will face the nation around the end of this year. Moreover, an intelligent decision on the revenue side of the budget implies knowledge of the spending priorities of an Administration and a Congress, a matter that by the nature of things can only be fully clarified after the election.

For all the developing consensus on the need for "supply side" tax reduction -- and I share in that consensus -- some time seems to me necessary to explore the implications of the competing proposals and to reduce them to an explicit detailed program for action. I have emphasized the need to achieve not only productivity improvement but also a lower trend of costs and wages; despite its importance, I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear more directly on the question of wage and price increases.

The continuing sensitivity of financial markets, domestic and international, to inflationary fears is a fact of life. It adds point and force to these observations and questions. Tax and budgetary programs leading to the anticipation of excessive deficits and more inflation can be virtually as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

I believe it is obvious from these remarks that a convincing case for tax reduction can be made only when crucial questions are resolved -- questions that are not resolved today. The appropriate time for decision seems to me late this year or early 1981. Fiscal 1982 as well as fiscal 1981 spending plans can be clarified. We will know if recovery of business is firmly underway. There will have been time to develop and debate the most effective way of maximizing the cost-cutting and incentive effects of tax reduction, and to see whether a tax program can contribute to a consensus -- a consensus that has been elusive in the past -- on wage and pricing policies consistent with progress toward price stability. To go ahead prematurely would surely risk dissipating the potential benefits of tax reduction amid the fears and actuality of releasing fresh inflationary forces.

I have spoken before with this Committee and others about the need for changes in other areas of economic policy to support our economic goals. Paramount is the need to reduce our dependence on foreign oil -- a matter not unrelated to tax policy. We need to attack those elements in the burgeoning regulatory structure that impede competition or add unnecessarily to costs. And I believe it would be a serious mistake to seek relief from our present problems by retreat to protectionism, at the plain risk of weakening the forces of competition, the pressures on American industry to innovate, and undermining the attack on inflation.

We are now at the critical point in our efforts to reduce inflation while putting the economy back on the path to sustainable growth in the 1980's.

I sense the essential objectives are widely understood and agreed -- the need to wind down inflation even as recovery proceeds; the importance of restoring productivity and increasing incentives for production and investment; the maintenance of open, competitive markets; a substantial reduction in our dependence on foreign energy.

You know as well as I how much remains to be done to convert glittering generalities into practical action: to achieve and maintain the necessary fiscal discipline, to make responsible tax reduction and reform a reality, to conserve energy and increase domestic sources, to tackle the regulatory maze. But I also know there is no escape from facing up to the many difficulties. Our policies must be coherently directed toward the longer-range needs. In that connection, I believe that economic policies, public and private, should recognize that the need for discipline and moderation in the growth of money and credit provides the framework for decision-making in the Federal Reserve.

* * * * * *

REDUCE GROWTH IN MONEY AND CREDIT GRADUALLY

Mr. **Volcker**. As I indicated to you earlier, the point that is made in the earlier part of this statement is that, so far as the Federal Reserve is concerned, we intend to continue to work toward reducing over time the growth in money and credit because that's the only policy that is consistent with winding down inflation over time. We don't think the economy is going to work satisfactorily over time, and we're not going to get the growth and productivity and sustained recovery we want if we don't break this pattern of successively higher levels of inflation in every cyclical movement of the American economy.

The point that is also emphasized in the statement is that if that's the appropriate background for monetary policy—and we firmly believe that it is—other economic policies and other economic developments may or may not be operating at cross purposes. To the extent they are operating at cross purposes, we will have less satisfactory economic prospects, to put it mildly.

One of the questions that arises in that connection is the tax question.

UNSTABLE ECONOMIC CONDITIONS PRECLUDE MAJOR TAX REDUCTION

I was up here in, I believe, April, and in introducing the testimony then, I had a few sentences about taxation. I think they are equally appropriate today. Certainly there is consistency in what I want to say, anyway.

I said then:

> We do want to relieve the burdens of taxation. We have very serious productivity problems in the country, as you know, and the tax policy is ultimately [as] important in dealing with that problem. So when you're approaching the budgetary problem, I think it's important you put the emphasis on spending, on the spending side, so that as savings materialize and as the budget is brought under control over a period of time, we can bring the day closer, the day that is not here now, when we can act on the revenue side of the budget to direct the tax structure in a more satisfactory way to support the fundamental needs for productivity growth.

I think that's basically the message that I would have this morning. I do not think the conditions have been put in place at this point for major tax reduction.

Chairman **Hollings**. That's the point I wanted to make, that conditions have not been put in place for a major tax reduction.

Go right ahead.

Mr. **Volcker**. I have several things in mind. One of the conditions is directly, most directly, the budgetary position. Beyond that, economic forecasting has become a very uncertain business. People are talking about a permanent tax cut, and everybody seems to be talking about something that will take effect next year, if it's done at all. We're not talking about some action this month, for an immediate tax reduction to deal on kind of a "quickie" basis with the recession. Everybody's talking, I think properly, about a more permanent approach. But yet, just when the action is taken, it should bear some relationship, particularly in the fragile budgetary situation we are in, the immediate situation in the economy. I don't know what that will be at the end of the year. There are some "flutterings," if I might put it that way, of a little better economic performance recently. I don't attach a lot of weight to that, but on the other hand, I think there is a possibility—there are several possibilities—as to how the business situation may evolve over coming months.

The most adverse development would be the kind of secondary reduction in capital spending, which we haven't had much of yet. If that does not materialize, if consumer spending does return to more normal patterns, if housing recovery starts—we've only had 1 month of that; it may be a real sign and maybe a false sign, then you have a much better looking economic situation as we move along.

That connection, I don't think the Congress can avoid recognizing that we still have, in a different setting, the problem that you were grappling with last winter, when expectations of a poor budget position were greatly contributing both to inflationary expectations and to the immediate pressures in the financial market.

We have had a remarkably rapid reduction in interest rates during this period. I think we see some evidence that the decline in interest rates, the relative ease of credit markets now, is contributing, in a constructive way, to bottoming out of the recession and recovery. The budgetary actions will have something to do with those conditions in the credit markets, through expectations alone. I suspect we have seen some evidence in the bond markets in recent weeks of a less confident tone, if I may put it that way, partly related to fears about deficits, fears of the possibility that the economy may again be overstimulated—and maybe that sounds ironic when we're in the middle of a recession, but that has been the pattern that many people have seen in the past. Stimulation comes late, it becomes excessive, and contributes to this recurring inflationary pattern.

One thing that I am basically convinced of, Mr. Chairman, is that if people expect and, in fact, it happens, that as we move into business recovery—as I am sure we will in time—this appears to be accompanied by more rapid rates of inflation than we have had in the past and we're ratcheting up that inflation rate further, then there will be adverse repercussions in financial markets and there will be adverse repercussions and behavior in other respects that are inconsistent with the kind of sustained, prolonged growth that we want to see.

Now, one other point that I touch upon in the statement, and I don't have any easy answers to this, is that all the other governmental policies and private policies tend to prolong inflationary momentum. There's the whole regulatory side which you're familiar with; I did refer earlier to the energy side a bit; there is a question, as I indicated before the other Senators came in, of what can we do to reduce the momentum of wage and cost increases, some of which are directly related to governmental actions, such as the payroll tax, the minimum wage and other factors.

Wage settlements themselves have been restrained in one sense relative to the inflation rate; I don't think we can complain from that point of view. On the other hand, in the national interest, the quicker those wage rates come down, the rate of increase comes down, the better off everybody is going to be, including the wage earner, of course, because that will make possible and lasting the kind of recovery we want, the kind of expansion in job opportunities we want, and I think create an environment in which productivity can increase. Nobody gets more real income unless productivity increases; otherwise we're only passing around money of depreciation value; the only way that real income goes up is when productivity increases.

So if we're going to talk about tax reduction, I'm going to raise that question and say, "Does it make sense to have a tax reduction if we're ratcheting up the wage level, and creating more inflation, if we're having higher wage guidelines?" It seems to me, if we're going to have wage guidelines?" they ought to be lower in this situation.

Those are some of the considerations that I have in mind in saying that I think it's very difficult to come to a judgment that the conditions are here for enacting a major tax reduction at the moment.

CBO PROJECTIONS FOR 1980-81

Chairman HOLLINGS. Mr Volcker, let's see if we can start at the same starting line with respect to the Congressional Budget Office projections for 1980-81 relative to real GNP growth, the Consumer Price Index, the GNP deflater, and unemployment at 8.9 percent for next year in 1981.

Do you have any significant disagreement with these projections? I just want to see whether we're both talking the same language here.

Mr. VOLCKER. I looked at these projections rather quickly last night. My impression is they are more or less in line with the projections that members of the Federal Reserve Board and the Open Market Committee have. In fact, the real GNP estimate for next year shows a somewhat more rapid growth, if I understand these projections correctly, than we have estimated in our own forecasts.

Let me say in this connection that these forecasts look reasonable. I don't have a great deal of faith in any forecasts, given the experience we have gone through in recent years. There's an inherent uncertainty here that should affect our policy judgments; we shouldn't lean too hard in one direction or another thinking we know what's going to happen, when we don't know all that well what's going to happen.

QUICK FIX FOR UNEMPLOYMENT

Chairman HOLLINGS. Well, we're generally starting then from the same starting point, with perhaps a little bit faster recovery anticipated by CBO than perhaps by the Federal Reserve.

I have just been given now your projections that you submitted before the Senate Banking Committee.

If we're now at the same starting point then let's make certain we're getting the right conditions in place, or we're taking the action so the appropriate conditions can come in place for a tax cut or for further fiscal action next year. What I'm trying to emphasize is—I take it we all agree there is nothing that we can do of a stimulative nature or should do of a stimulative nature, between now and November 4 to ameliorate the high unemployment rate which is forecast at approximately 8.8 to 9 percent by November 4.

Is there any kind of stimulative action that you would suggest to ameliorate that?

Mr. **Volcker**. I would think the most constructive things that could happen during that period are two things that are already happening. We have got some automatic impacts on the budget, as we touched upon earlier, the so-called automatic stabilizers. But equally important, perhaps more important, is that the natural forces in the financial market have moved in a direction that helps support the turnaround in the economy. Let me make clear that it is not because we pushed up the money supply in any inflationary way. In fact, we're low on our targets. But the natural reaction in the market to declining credit demands, the natural reaction in the market to some receding of the extreme fears about inflation, is still very sensitive. The extreme fears have receded. This has produced a much more favorable climate in the long-term bond markets. We have had record volumes of financing recently. The mortgage market is clearly improved; it's not back to where it used to be in the good old days, but money is still available at around 12 percent, which is a lot better than it was a few months ago. That is reflected, I think, in these signs, at the minimum, of some slowdown in the rate of decline in the economy and, in some sectors, by some very tentative signs of movement in the other direction.

TARGETED TAX CUTS

Chairman **Hollings**. There are encouraging signs. But once again, as we mark up our second concurrent resolution—we, from a budgetary standpoint, should be generally in lockstep with the Federal Reserve. If, for example, talking in not necessarily the extreme, but if we were to give a tax cut at this particular time to try to give the right signal to business, and to encourage productivity, if we give that tax cut at this time the Federal Reserve will look upon it as an adverse or unwise signal, as you say it, so we have a timing situation and I want to get in lockstep.

BROAD TAX CUTS NOT ADVISABLE AT THIS TIME

Mr. **Volcker**. Let me make a distinction. We have been talking very generally about tax cuts. When I'm talking about tax cuts, I have implicitly in mind something of very significant size—$25, $30, $35 billion; the discussion has been in that range.

I was not thinking of a possibility which I think could be put on the table, of limiting tax action to something directed very explicitly and directly toward the investment incentive savings problem. There are approaches there, as you know, for which you're not talking about $25, $30, or $35 billion. You're talking about maybe a very few billion dollars, which is obviously easier to "shoehorn" into the budget in the appropriate circumstances and could be effective in going to not only the short term but the longer term problem——

Senator **Chiles**. Give us a more explicit example of what——

Mr. **Volcker**. There are several approaches that can be taken on the investment side. You can take depreciation reform; you can take the investment tax credit; you could even take the corporate income tax rate. There are some differences among those approaches in the way they hit particular industries; there are differences in those approaches, certainly in the short run—the short run being a number of years in this case—as to how much incentive or how much push you get per dollar of revenue lost.

As you know, there has been a lot of discussion on these various approaches; putting together something in that area in my judgment could be constructive, even if its constructive nature should not be measured by relatively small losses in revenues.

OUT-YEAR REVENUE LOSSES FROM SMALL TAX CUTS

Chairman **Hollings**. Now, that small loss—and I'm going to come back again to our stimulative question, but I'll follow you right here so that we can be coherent. The small loss is the approach of all relative to their submissions on investment tax credits, corporate tax cuts, depreciation allowances, but all of them in the outyears grow very, very largely.

Are you saying then to keep the revenue losses small, not to grow in the outyears?

Mr. **Volcker**. I don't want to be understood as saying that any tax program that happens to have a very small impact in the first fiscal year is great if it has enormous revenue loss in the outyears. I think we have to look at those, too. Something like "10-5-3" does have a very rapidly escalating revenue loss in the outyears. I'm not suggesting you just go ahead lightly with anything in that area. It takes a careful look.

I want to put that in a little different category than across-the-board tax cuts. I think it's important, given, as that you're going to have budgetary constraints as far ahead as I can see, that the Congress look very hard, in the process of reviewing tax options, for those areas where you get the most bang for the buck, in terms of productivity and incentives.

1981—YEAR FOR LARGE TAX CUT

Chairman **Hollings**. But the question is whether we go at all this particular year, for——

Mr. **Volcker**. Right.

Chairman **Hollings**. For the remainder of 1980, and actually provide one to take effect in 1981, or whether it is more judicious to await next year, have better figures, have more of the conditions in place. In fact, I was following your general line as we began early this morning, even before some of the other members came, that it would be unwise to have any kind of tax cut right now, not even de minimus, not even small, not even large, because we are now sending to financial market the wrong kind of signals. When the Congress comes back with having had a balanced budget, now it's $30 billion in deficit, having had only a smaller deficit in terms of $45 or $46 billion, and now it has jumped to the expression "over $60 billion."

Mr. **Volcker**. That is my basic position and feeling, Mr. Chairman.

The other comment is in the nature of a footnote: I see no reason for not waiting on that portion, too, because if there is any possibility of a bigger package, you can put it together in that package. I don't see the conditions for that bigger package. But I must confess, if somebody said, "Well, I'm not interested in the bigger package. I realize we can't give up much revenue now, and I don't want excessive loss in the outyears." I don't have the same extreme sense of concern about that approach. I don't think people are talking about that approach. I think people are talking about a bigger package, and I think it is wise to reserve judgment on the whole package, as you suggested, and put it together in the most effective way.

In fact, I do not think as I read it, that the Congress is ready to go ahead on the investment side right now, in the next month or two, with a consensus, on technically, on the best way to do it. I think we're a lot closer to that consensus than we have ever been maybe, but I don't detect that it's right here now in a kind of enactable bill, and I would suspect for that reason alone it's going to take some months, even if it were confined just to that area.

SHORT-TERM UNEMPLOYMENT ACTION

Chairman **Hollings**. Once again, I have my own feeling about stimulative type fiscal provisions in this second concurrent resolution. I want your view, your opinion. I can put it in more colorful terms. Governor Reagan, he gives hope. Now comes the members from some of the automobile manufacturing States with this tremendous high unemployment and what have you, and they say "at least the Republicans are giving us hope; do you think we're going to sit around here as a Budget Committee and not give hope between now and November? We have to have some kind of stimulative approach. We've got to give them hope."

Is there any kind—can we really give them any hope?

LONG-TERM HEADACHE FROM SHORT-TERM FIX

Mr. **Volcker**. I was thinking of something more basic than the nature of a "quick fix." I really would fear the kind of action that one has to take in the kind of time frame you're talking about, and under the kinds of pressures that you're suggesting. The kind of thing that's thought about as a "quick fix" turns out to be tomorrow's headache. I think that's very likely to be the case.

I don't think just pumping purchasing power into this economy is what the doctor ordered. What you're going to find, and I suspect you might find in the very short run, is that it does more damage to the climate in the credit markets than the good you think you're getting from the fiscal stimulative action, so the promise of some recovery, let's say, in housing, is dissipated.

Then you would come back and ask me and others what went wrong. What went wrong is you were dealing in a situation where unfortunately you cannot ignore the fact of life that people are hypersensitive, most of all in financial markets. It's endemic in the economy, it's epidemic, that they are suspicious of what's going to happen to inflation. Expectations and the actuality of rising inflation are not, in my opinion, going to be consistent with successful stimulus.

CONDITIONS FOR A TAX CUT

Chairman HOLLINGS. Very good.

Getting the conditions—that the conditions have not been put in place yet for tax reduction, or the proper atmosphere, as to inflationary expectations. You, the Chairman of the Federal Reserve, all the bankers come in and you say one of the greatest factors is the Federal budget.

What would you hope for this committee to do on this second concurrent resolution, or what are your greatest—you know, it's so easy for the banker and the business leadership to criticize the politicians. We're used to it and we love it. That's why we stay in it. I can see you back in that big, great office there, saying "those fellows down in Washington, if they hadn't done so-and-so, if they would only do—" I want that list. I want those things not to do and those things to do, from your standpoint, so that I'll know where you're headed, so I'll know where I'm headed, and see whether or not we can get in step.

Mr. VOLCKER. I think I will be very practical and appreciative of your problems in what I am about to say.

You can't absolutely lock this in, but any budgetary resolution, any congressional process, at this stage, should avoid any further increases in the present outlook for the expenditure side of the budget; that is a minimum requirement. I hasten to add that does not, in my judgment, by itself, suggest to me there is a foundation for large tax reductions; that's just preventing going backward. It might possibly provide a foundation for at least some selective revenue losses, aimed directly at this productivity problem.

Chairman HOLLINGS. So the first order of business is to avoid any further increases in expenditures; that would be a sort of first round creed or principle to build into this second concurrent resolution.

What other conditions are there?

Mr. VOLCKER. Again, if there is any talk of permanent tax reductions extending out over a period of time there is an unknown in the equation, that I suppose, inevitably this committee can't deal with—and that is the basic planning beyond 1981. That inevitably is something we cannot have a reasonable feel for until after November 4.

Chairman HOLLINGS. Until after November 4. So we would avoid expenditure increases and for the time being we would avoid a comprehensive tax cut or any kind of approach at this time; is that right?

Mr. VOLCKER. That's right.

FED SUGGESTIONS FOR BUDGET RESOLUTION PROVISIONS

Chairman HOLLINGS. I want to make a good grade, a good mark. How could I make an "A", how can I make a hundred on your exam, assuming it's October, and I want the list from you of the things we ought to do and ought to be in this second concurrent resolution. You have told me two things.

TAX CUT DOLLAR FOR DOLLAR SPENDING CUTS

Mr. **Volcker**. If we were in school with the textbooks and didn't have to worry about all these realities, I think you ought to be in there cutting that projected spending figure. You could cut it. I'll give you dollar for dollar, in terms of tax reduction on the other side, on everything you cut there which I think would be a healthful balance.

Whether you think that's an appropriate kind of mark outside the textbooks is the question. I think in the real world I would give you a high mark if you could give me a real internal feeling of that the present figures are going to be held.

Certainly there are other things going on, but I don't think that provides, by itself, a comfortable backdrop for a big tax reduction.

Chairman **Hollings**. Very good. I appreciate that.

Let me yield to Senator Bellmon.

Senator **Bellmon**. Thank you, Mr. Chairman.

First I want to apologize for being a little late, Mr. Chairman. I had an office full of generals and had a little controversy going with them, so I am sorry I was not here to hear your comments. I hope what I'm going to get into hasn't already been covered.

Chairman **Hollings**. It probably was covered. I used some of your approach about the Federal Reserve being raison d'être for this terrible fiasco of losses of billions of dollars, that they acted entirely too precipitously, they acted too late, they acted with total disregard for the budgetary processes; they ruined your good work and my good work. [Laughter.]

Mr. **Volcker**. You can assume that that's not all true. [Laughter.] We always get the other side of this, but I was happy to note that the latest budgetary estimates show a substantial decline in Federal interest cost, and spending is going up despite that.

Senator **Bellmon**. I have a written statement, Mr. Chairman, but for the sake of time, I will ask it be put in the record at this point.

Prepared Statement of Senator Bellmon

Mr. Chairman, I also wish to welcome Mr. Volcker to our Committee this morning. Our experience with the economy since his last appearance certainly underscores the importance of his remarks to the work of this Committee.

In March, financial markets participants, most economists and even some in Congress were pressing the Fed to slow down the economy so that runaway inflation could be reduced. Well, judging from the past few months, the economy not only slowed down; for a brief period, it collapsed. I can't help but think of an old maxim: Better be careful what you wish for, you just might get it.

From my experience with the Budget Process, I realize how difficult it is to chart a policy course that is generally satisfying to all constituencies. However, this morning I intend to pursue the issue of how monetary and fiscal policy can better coordinate to avoid these sudden policy shocks that clearly no one wants. Such shocks and their aftermath are disruptive to the economy, to those who suffer unemployment or lost income, and, in fact, to the very economic policy-making process itself.

Looking back for a second, I am convinced that the experience of the past 10 years underscores the futility of "retrospective economic policy," if I can coin a term. Both monetary and fiscal authorities have been afflicted by a "recognition lag," whereby they seize on a policy goal only after circumstances have become so acute, that almost no policy could possibly be effective. This leads to radical shifts in economic policy to address the last problem. These shifts in turn too often lay the seeds for the next crisis.

I think that the Federal Reserve has taken an important step to remedying this situation for monetary policy with the new operating guidelines it adopted last

October. The Federal Reserve has set a firm course in terms of money supply growth, and interest rates will fluctuate as demand for credit in the economy changes.

As a result, interest rates have fallen to almost half of their April peaks in response to the weaker economy. Only once before in the post-war period have interest rates declined in the first months of a recession. This decline in interest rates gives me confidence that the economy will recovery promptly! In fact, I believe that this recovery will come sooner and be more brisk than most economists expect. Chairman Volcker should be commended for these policy changes, but I think that they are only a first step if the Federal Reserve and the Congress, together, are ever going to initiate policies that successfully promote economic stability.

In part because of the steepness of the recent decline and in part because of present high tax burdens on both individuals and businesses, Congress is under extreme pressure to enact a tax cut. In the past I have advocated a policy of general fiscal restraint and balanced budgets, so that monetary authorities will have the flexibility to deal with economic changes in a more timely manner than we can with fiscal policy. We appear to be on the threshold once again of stimulative fiscal actions that will increase Federal borrowing, reduce monetary flexibility and may possibly provoke a rise in interest rates.

I hope, Mr. Volcker, that you will comment this morning on the response of monetary policy to tax reductions and large deficits. I also hope that you will provide us some assessment of financial markets and the likelihood that a large deficit spawned by a tax cut will reignite inflationary expectations and interest rate pressures.

I hope that you will also interpret for us the Fed's intentions to reduce the monetary growth targets. If this means that monetary policy will become still more restrictive, I cannot see how Congress can avoid the temptation to add stimulus.

Finally, I hope that you will address the general problem of coordination of monetary and fiscal policy and outline for us the fiscal policy parameters—in terms of spending, taxes, and the deficit, which you believe to be consistent with your monetary policy objectives.

This is quite a tall order, I realize. But I am genuinely interested in your comments and appreciate your making the effort to be with us today in the face of a very demanding hearing schedule.

RESULTS OF RESTRAINED MONETARY POLICY

Senator **Bellmon**. In spite of what has been said, I hope you would count me as kind of a friend and supporter of the Fed. I recognize the actions that have to be taken when the economy overheats, as it was a few months ago, are probably politically impossible. If it weren't for the monetary managers, I don't know how we would ever get the economy to cool off when those situations arise.

But, having said that, I am curious to know if the Fed wanted the kind of result that we're now getting with this recession when it adopted the restraints on monetary policy that were put in place in various steps——

Mr. **Volcker**. Of course not. I think the——

Senator **Bellmon**. You said "of course not"?

Mr. **Volcker**. Yes. The essence of the problem as I see it—we discussed this a little bit earlier—is that the economy, in a sense, was in a "no win" situation. It was going to take off on a further built-in inflationary escalation at that time, unless some restraint was exerted. There was a risk of recession. That risk has been an old one in the sense that there were premature conclusions. We were in recession as long ago as last summer.

I am convinced that if the other alternative had been taken, of underwriting the inflationary expectations and the inflationary trend, we would indeed have had a recession anyway. The timing may have been slightly different, but we would have been in a worse position ultimately, I think, without any question.

PROJECTED UNEMPLOYMENT RATE UNACCEPTABLE

Senator **Bellmon**. I notice in this report which you have given us, the Midyear Monetary Policy Report to Congress,[1] which I haven't had a chance to read, you are anticipating the unemployment rate through 1981 to be somewhere between 8 and 9.25 percent. Mr. Chairman, politically, that's just not acceptable. I'm not going to be around here, so it doesn't worry me very much. But I think I can assure you, that if unemployment is still running at 9 percent a year from now, something is going to be done here in Congress.

ECONOMIC PROJECTIONS NOT INFALLIBLE

Mr. **Volcker**. Well, I am obviously conscious—I think all of us are—of that being a totally unsatisfactory performance of the economy. I, myself, am not in that gloomy a group on that score, and I would say again what I said to the Chairman earlier; I have a limited amount of faith in any economic projections.

I am reminded in looking at the projections that the Board of Governors made last year in the middle of 1979—which had a fairly substantial range, as these do—that the actual results were outside the range they projected, even though the range was considerable. In fact, the actual result in both cases—the unemployment rate and the real growth—despite the fact they knew 6 months results, was that they managed to underestimate the growth for the year and were outside the range. They overestimated the unemployment rate. So while we go through this process with some care, it's not certain.

Putting it in this report does not make it a reality.

Senator **Bellmon**. You're telling us to disregard these——

Mr. **Volcker**. Not disregard, no. I am saying that this is the kind of tenor of responsible economic opinion now, but one must attach a considerable range of uncertainty to it.

Senator **Bellmon**. Our problem is, we're getting the same kind of estimates from CBO and from the administration, and now you come along and reinforce it.

Mr. **Volcker**. We looked at those, too. These are quite similar to the CBO's projections and ranges. I think, on balance, CBO's range is higher for the recovery next year. We didn't assume a tax cut, of course, and I don't think they did, either. I think the assumptions are probably reasonable, so far as fiscal policy is concerned, and similar.

TAX CUT A POSSIBLE REMEDY FOR UNEMPLOYMENT

Senator **Bellmon**. I would think that most people, even hard-hearted economists, would agree that when you've got that kind of unemployment projection, a tax cut is one of the remedies that ought to be considered.

Mr. **Volcker**. The idea of a tax cut, conceptually, I find extremely appealing, because if there's anything this country needs it is action that goes to incentives and productivity. The broader question is whether the conditions are met and whether, on balance, it will be constructive or destructive. Theoretically, if you just look at the tax position alone, you say, "OK, we're in recession; the unemployment rate is high, intolerably high; let's cut taxes forever; and the more we cut them, the better we'll do."

---

[1] See p. 343.

Now you're obviously not going to accept that position. It's ridiculous. The real questions are, how much is enough, what are the other factors that impinge upon that decision and make it unwise instead of wise? In the most immediate sense, and in terms of concern over the business recovery—which I'm concerned about as much as anybody—if the net result of the wrong kind of tax cut or wrong amount of tax cut or wrong timing of the tax cut is to reinforce inflation and inflationary expectations, in my opinion you will not get those favorable effects on unemployment. You certainly won't get them for any length of time that you would like, and we'll be right back in the same position we're in now.

It's not a question of not worrying about the unemployment rate. The question is, how can we best deal with it? If we've learned anything over the last 10 years, let's hope we have learned we had better take these short-range measures, and fit them into a longer term policy and perspective, because if we don't, the policy is going to jump up and bite you in the opposite way from what you hope.

TAX CUT WOULD LEAD TO HIGHER INTEREST RATES AND INFLATION

Senator **Bellmon**. Let me say that my opinion is that we should not have a tax cut, for the reason that when we have a tax cut and borrow the money to provide for it, you simply set in with higher inflation, higher interest rates, and we're back in the same roller coaster we have been on in the past.

I have felt since we have had the Budget Committee here in the Congress that one of our major responsibilities is to try to figure a way to help produce a stable economy. We haven't done very well.

Mr. **Volcker**. That is right.

AVOID OVERCORRECTING THE ECONOMY

Senator **Bellmon**. I think the problem is that somehow or other fiscal policy, monetary policy, aren't working in very close coordination. I don't mean that as a criticism, and as I say, I think the Fed was the only vehicle that was available to help cool off inflation when it was getting so much out of hand here earlier this year.

But my concern is that—well, for instance, if I had a teenage son who knocked a baseball through a neighbor's window, I don't think I would amputate his arm. I think we may have gotten into that kind of overcorrection for the economy somehow, and I don't think anybody intended it. I don't know whether we have learned any lessons from that or not, but now we're in a situation where we're going to have another $30, $40, $50, or $60 billion dollar debt in fiscal 1981, plus another $16 or so billion in fiscal 1980. Then this adds to the cost of our debt service in future years.

It strikes me that something is terribly out of sync or out of—we just aren't using the tools we have very wisely. My question to you is, what can we on the Budget Committee do to help prevent these undesirable results.

SHORT-RANGE MEASURES MUST COINCIDE WITH LONG-TERM POLICY

Mr. Volcker. I think things are out of "sync," as you put it. They're out of sync partly because of the long-term effects of a succession of short-range quick fixes that are catching up with us more fundamentally. The inflationary climate and the lack of productivity are the sources of our difficulty. What we have to do—and I'm quite optimistic in a sense; I think there is a realization of what we have to do—is work on some of the underlying problems, in a consistent way, and a persistent way over a period of time.

In the framework of that general philosophy, and I would put in, quite specifically, that the need for a tax reduction is urgent in terms of the basic problems of the economy. How do we create the conditions under which we can act on that fundamental, long-term desirability of tax reduction. It has often been remarked that taxes are implicitly and explicitly going up, and I see the budgetary problem and the problems of the budgetary committee and the Congress, not just this year but persistently, as how can we reduce that upward trend in the level of Government spending and how can we get Government spending down as a proportion of the GNP. It's obviously a problem now, but not just for now. How do we offer the prospect that we can make progress not just in 1981, but in 1982 and beyond? I think that's going to be your problem for the decade. It's going to take push, push, shove, shove, and you know how difficult it is. But I don't see any other way of setting a continuing backdrop for what we really need to deal with, what you referred to as the economy being out of "sync." We've got to get this productivity rate up; we should have more incentives; we should have less pressure on costs. The underlying budgetary contribution has to be that of year after year getting spending lower relative to the economy.

Senator Bellmon. Mr. Chairman, we have five bells now, and that means we only have a short time to vote. Our chairman will be back momentarily. If you would excuse us, we'll go vote.

[Whereupon, the Committee was in short recess.]

PHASED-IN TAX CUTS

Senator Chiles [presiding]. We'll pick up again until the others return.

I am sure you have seen some of the statements by the Committee to Fight Inflation, headed by Dr. Burns.

Mr. Volcker. Yes, sir.

Senator Chiles. I note that there's a pretty good mix on that committee, in that they are from some of the former centers of all of the administrations who had some responsibility in former times—and I guess they're doing work of conscience now in an effort to tell us what we should be doing to undo the policies that occurred during the times that they were supposed to be in charge. I note that they now all generally say that while those policies were put into effect, they generally advised against those policies, so I want to give them that.

I note that they are talking about a tax cut that would be phased in, and I wondered if you had a chance to see that. As I understand it, it would be very small numbers in the first and second years, 1981 and 1982, but would sort of be a guarantee to business, that over 5 to 7 years this tax cut would be coming, their theory being that business could make its plans and that that would be a sound policy.

Mr. Volcker. Yes. I think that's an idea that Arthur Burns offered some time ago.

Senator Chiles. Yes. I know he talked about that.

BUSINESS INVESTMENT TAX CUT

Mr. Volcker. I'm a little fuzzy on precisely what Dr. Burns' committee said, but my recollection is quite clear that they were talking about a rather explicitly directed business investment type tax cut, as in some of our colloquy earlier. I think that kind of thinking is precisely along the lines I was indicating as a kind of footnote earlier and that that kind of tax approach could be separated out from this broader version of a tax cut. I don't think it's particularly wise right at the moment, as I indicated, because I think if there's any question of a bigger package, you had better explore all the aspects of that package.

If there were a decision to take a rather narrow, selective and, I think, potentially constructive approach of that sort, it would not make the budgetary constraint quite so difficult.

Now, there is one problem with the 10-5-3 approach which I think is much bigger than they're talking about. You have got to be a little careful about promising a businessman an incentive next year, or 2 years from now, or a bigger incentive, for fear that he won't act now, that he will just delay and wait until he gets the incentive. You have got to design the incentive so that he doesn't think he's got an advantage in waiting.

Senator Chiles. I agree.

Mr. Volcker. There are all kinds of ways of drafting that.

Senator Chiles. I think that's a very valid point, and I think what they were talking about was trying to design it so that it is phased in but that it would cause him to initiate their business investments, so that immediately——

Mr. Volcker. That's a matter of technical design. It may not be so easy to do, but there are technical ways you can accomplish that result.

If I can just add a thought, there are limitations to what you can do in this area, I think, simply because of credibility. What Congress does this year they can undo next year. It's very hard to get the same impact from a future promise, so to speak, as you get from action that is actually taken. It's just another question of the design of that kind of approach.

Senator Chiles. Again, I think it's a very valid thing. It may be if you could draft the legislation of the tax cut like that, so that you actually are legislating it, and it just is phased in over future years——

Mr. Volcker. Phased in in a way so that their activities this year will get whatever benefit is legislated in the future.

Senator Chiles. Right.

Mr. Volcker. I think it's technically possible to do it.

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE ACTION WOULD INCREASE MORTGAGE RATES

Senator **Chiles**. The strength of the housing sector is very critical for our economy, and all of the economists that we have listened to this week have agreed that housing led the drop in the recession this spring. Of course, it remains a big question mark in the level of recovery that we anticipate. The drop in housing is usual, even though it has followed a rapid increase in interest rates. Usually we see housing choked off because the high interest rates draw the money away from the savings and loan institutions.

This year it appeared that that was a little different. Thrifts did have money, but the rates themselves finally went so high that the people just decided, once it hit over 14 percent, that appeared in my State to be the magic number. There were some loans made beyond 12 percent, even in the 13 percent range. But when it hit 14 percent, that was it. That stopped everything.

It seems that the recent actions in the Depository Institutions Deregulation Committee, of which you are chairman, might cause a repeat of that situation, by setting a floor on the ceiling rate that the thrifts and the banks can pay for money, for moneymarket certificates, and then eliminating differentials. You're forcing the thrifts to pay so much for the money that they're to get in that they're never going to be able to charge less than 12 percent for that home mortgage.

Mr. **Volcker**. I don't think that's correct, Senator.

Senator **Chiles**. Can we really have much of a recovery if we're going to keep that rate pegged, say, at 12 percent?

Mr. **Volcker**. The intent and substance of those actions I think are quite different than your remarks suggest. I'm glad the question arose because I think there has been a certain amount of confusion and I can only say wrong-headed thinking as I see it.

Let me explain what we had in mind and why I think it is basically constructive. First of all, you've got to start with the general proposition that the mortgage market, in a broad way, is going to reflect what's going on elsewhere in the capital markets. Mortgage rates can't be at 10 percent and bond rates at 12 or 13 percent, or vice versa. If the bond rate is down, it will bring down the mortgage rate. There's an interconnection between those markets. The mortgage market is only part of the whole capital market.

DIDC ACTION TAKEN TO HELP MORTGAGE MARKET FUNDS

But the changes made by the Deregulation Committee had several intents. The most important and most significant thing that we had on our minds was to put all these institutions—the savings and loans, the savings banks, and particularly the smaller commercial banks which, of course, among other things, do a lot of mortgage lending—in a better competitive position, and a better competitive position vis-a-vis the Treasury securities market, where there's a lot of individuals money that might otherwise be flowing into those institutions, particularly in the money market funds which have been growing extremely rapidly and, of course, do no mortgage lending and no agricultural lending and no small business lending. The first thing we wanted to do was make sure these institutions got their share of the money, so to speak, so we raised all the rates relative to Treasury security rates and put them in a better competitive position.

Then, for somewhat the same reasoning and with the plus that we are supposed to be deregulating anyway, it was our thought that we would put a floor on these ceilings, because if there was a temporary dip in the money market rates, it didn't seem to be particularly constructive to force down all these deposit rates for a limited period of time at the expense of these institutions getting the money. It was a tradeoff. The lower the rates, the less money they'll get. We were concerned, again, about improving their competitive position and getting an inflow.

Now, so far as——

CONCEPT OF DEREGULATION QUESTIONABLE

Senator **Chiles**. It looks to me like that second action you're taking is exactly the opposite from saying you're decontrolling, because you're not going to allow them to determine their policy.

Mr. **Volcker**. No; we don't say they have to pay that rate. All we're saying is, "When the Treasury rate gets low enough, make up your own mind. We're not going to force you to go down."

Senator **Chiles**. But the effect of that with the thrifts is to say they are going to have to pay it, because they all have to follow that. When one goes, they all have to go. The effect of that is to say it.

Mr. **Volcker**. I think that is a problem. We haven't lived in an uncontrolled world in that industry or in the banking industry, where there's a similar tendency. I don't think that problem would last indefinitely, but it is inherent in deregulation, and we have not faced up to it yet, in my opinion. We'll see how this deregulation goes.

If what you say is literally true, and it's going to be true indefinitely, I think you're saying deregulation won't work. This is an element of deregulation; you're questioning, I think, the whole concept of deregulation.

The notion was that these floors, if we stayed with them long enough, would be low enough in any event as to be consistent with a sizable decline in the mortgage rate, in the opinion of the committee.

We were concerned also—and it's reflected in our actions—about this very sensitive question of the differential and the relationship among institutions, which I have the impression preoccupies them. I don't think it's the most important thing—their competition with others is more important in my judgment—but it preoccupies them, and one can understand why.

LONG-TERM MONEY PROVIDES BASIC ASSURANCE TO MORTGAGE MARKET

So the savings and loans were left in a maximum effective competitive position, in the framework of earlier regulations, with respect to the 2½ year certificate, on the theory that they had had a differential in that area in any event, that these kinds of deposits are by far the most suitable to support mortgage lending, and that the more money they got in those deposits, the more confident they would feel about making mortgage loans. They had been stuck with making mortgage loans on the basis of 6-month money, and they were badly wounded; even a sizable inflow of short-term money does not provide the same assurance to the mortgage market as the longterm money, so we tilted our action in that direction.

Insofar as the 6-month certificate is concerned, there was a very complex situation because all the institutions had been living without a differential for some time, de facto. There was concern—I think legitimate concern—about eliminating the differential, or reinstituting in practical effect the differential completely, for fear of draining sizable amounts of money from smaller banks. And while housing is one priority, so also are loans to agriculture, so are loans to small businesses, so are loans to automobile dealers, and indeed, so are the housing loans that the small banks make.

There was a pragmatic judgment that the differential would be less than the operative range—and the range has been operating virtually throughout this period—but that so far as an existing certificate, a bank could roll it over at the same rate as the savings and loan, to avoid a drain. This puts them in a less favorable competitive position on new money, but on the same competitive basis in retaining the old.

INCREASED SAVINGS DEPOSITS

What has happened since those decisions is not uninteresting. First of all, much to everybody's surprise, savings deposits have gone up; these were not touched by our actions and have a very low ceiling. For the first time in many months, savings deposits at both banks and thrift institutions have gone up.

The thrifts have had a good result, I think, on the 2½-year certificate, which was anticipated and encouraged. The banks have also done pretty well on those 2½-year certificates. Both groups lost 6-month money in some size, as to the total of 6-month money and ½-year certificates for banks it went down in June, seasonally adjusted; for thrift institutions, the total went up significantly.

The only reservation I have in my mind, in looking at those numbers, is that the upward trend is perhaps not quite as much as I had hoped, certainly relative to the moneymarket certificates, and to the moneymarket funds, which continued to expand at an enormous rate. The only conclusion I can draw from that is that the general thrust of the committee decision was correct, because they would have been worse off if those rate ceilings were lower; they might not have gotten any inflow of money at all.

They didn't get all that much money. It's positive, it's plus, it's constructive, but not as big as I had thought, to give them a little more competitive elbow room. But there is nothing that has happened to cast any doubt at all in my mind—oh, you can argue about the details, but the general thrust of what we were trying to do in that committee.

Senator Chiles. Well, I think the question is, not one of whether they're getting deposits, but what they're having to pay for those deposits, and therefore, what they're having—the rate that they'll have to loan.

CASH FLOWS CONTINUE TO SUPPORT LOWER MORTGAGE RATES

Mr. **Volcker**. In a general sense, that's determined by general market conditions. Our choice in the regulatory sense of that committee is, given market conditions, and given the fact they're going to have ceilings as the law requires, are they going to be in a little better or little worse position? We say they are better off paying a quarter of a percent more and getting some money, at these rate levels, than paying one-quarter of 1 percent less and not getting any money. I don't think you can have it both ways; the lower you put those ceilings, the less inflow they're going to have.

These ceilings are low enough, I might say, in my judgment, if the flows continue, to support lower mortgage rates than those now prevailing in the market. In other words, the 6-months certificate rate has been between 8 and 9 percent for a long while. The 2½-year certificates, which has been at its floor for a savings and loan is 9.5 percent. When you compound the rate it's higher, but the mortgage rate is also compounded. That, in my judgment, is more than a sufficient margin against current mortgage rates.

In other words, if they had an adequate inflow of funds at those levels, and as that inflow continues, as I suspect it will, even at the existing level of the market rates they are in a position to do a good deal more mortgage lending.

Senator **Chiles**. Well, I thank you for your answers. I would like to have an opportunity to kind of reflect on them.

This is a question, Mr. Chairman, I would like to go into further after we finish our markup, because I think the strength of our housing market is tremendously important to what we're going to do.

Mr. **Volcker**. I, of course, agree with that general conclusion, and apart from the regulatory concerns——

Senator **Chiles**. My fear is, what we're doing is we're pegging the market and we're sort of keeping it from being able to fluctuate on the down side, to continue to come down.

DIRECTION OF LONG-TERM INTEREST RATES IN DOUBT

Mr. **Volcker**. I think mortgage rates have room to go in that regulatory structure. Yours might be a relevant question if they went that through the distance, and you could say, "Well, you know, they really can't go any further if they're going to continue to pay those rates." Then the committee would only be faced with kind of a dilemma. We're supposed to be deregulating, not telling those institutions that they have to pay lower rates if they choose to pay them at their own volition, but the option always exists to lower the floors. Let's not rule that out a priori, but I don't think it's a relevant consideration right now, given the current level of mortgage rates.

The concern about mortgage rates I have comes from quite a different direction: what is the condition of the total capital market, because those mortgage rates are not going to go significantly lower than bond rates. Why should they? The lenders would just go into bonds instead of into mortgages. So the relevant question at the moment is what direction the whole structure of long-term rates is going to go, and that becomes very relevant to this committee. I have to observe as a simple fact—and it's always hard to figure out these various impacts—that the bond market stopped going down and went up a little bit as we had more and more talk of the announcement or the leak of the $60 billion budget deficit next year and increasing talk about cutting taxes. Look at what happened in the market: We have long-term rates one-half percent higher than we did 3 or 4 weeks ago. It's a question of cause and effect, but it's suggestive.

Chairman HOLLINGS. That about our Treasury borrowing, too. There's a factor, too, that goes into the——

Mr. VOLCKER. The market is looking at the increased deficit, the increased Treasury borrowing, the fear of further deficits. In my judgment, at the very least that contributed to this pause in the bond markets.

IMPACT OF BUDGET RESTRAINT ON INTEREST RATES

Chairman HOLLINGS. Mr. Volcker, you have not felt it wise, I understand, to give any money growth targets for 1981. But what assurances can you give us that the budget restraint will be accompanied by interest rates consistent with recovery?

Mr. VOLCKER. Let me describe our policy and give you an answer to that question from our perspective.

It is our intent to work toward lower growth in money over time, and we would approach 1981 with that view in mind, that there should be some lowering of these targets. We should fix our money supply at a somewhat lower target than we had this year; that should be fixed in place, so to speak.

The question of what happens to interest rates, that is our basic policy decision. The question of what happens to interest rates is then based on what demand there is for that money, how much inflation is there, what is the growth in the GNP and all those kinds of questions.

I think you can say two things without much fear of contradiction. First the more inflation we have and the more expectation of inflation we have, the higher interest rates will be. That's the direction in which that influence goes, quite clearly, given any particular amount of money. I think you can also say that the bigger the government deficit, the higher interest rates will be, given that money target. That's not the same as saying interest rates have to go up; there are other kinds of influences; it will depend upon the growth in the economy. But I would be concerned that with recovery, which uses more money and more credit—and obviously should use more money and more credit, that's the healthy thing—that with the real recovery of the economy in reasonable proportions.

MONETARY POLICY ALONE INSUFFICIENT TO DEAL WITH INFLATION

The more inflation we add on to the top of that, the more deficits we add on top of that, the more the risk is that we will have an increase in interest rates that begins interferring with the recovery we want. That's the dilemma we're in. It's just terribly important not just that monetary policy be aimed at dealing with inflation, but that other policies be aimed at dealing with inflation.

There is no way you can say the Federal Reserve will take care of inflation, and we'll do what we want to do—I don't mean the Budget Committee, but the Congress and the administration as a whole—because you're going to run into conflicts. There is no magic machine in the Federal Reserve that decreases inflation automatically when the money supply declines. You want to smooth that transition. We press in that direction, but we run into a conflict if other policies run in an inflationary direction.

I think the answer to that dilemma that has been given many times in recent years is, "Ok, increase the money supply." That has happened on a number of occasions at least de facto. I think it's precisely that kind of response that puts us in the dilemma we're in now, and it gets worse every cycle.

MONETARY RATE FOR 1981

Senator **Chiles**. Well, our problem also has been in the past that we had the Fed going off on one policy and the Congress and the administration going off on another. Of course, what we have been talking about is trying to get monetary policy and fiscal policy closer to being on the same track.

Let's ask the question this way: Given the budget that we're now dealing with, which now the numbers are saying what we thought might have been a balanced budget is now going to be out of balance, $20 billion to $30 billion; but given that 1981 budget that we're now working with, how does that fit in with the monetary policy that you see the Fed putting in which is to further cut the growth of money and where you see the interest rate—you've got your "cards" and you're not disclosing your "hold card" of what that monetary rate is going to be in 1981, but our cards are on the table right now. You ought to be able to give us the answer to that.

Mr. **Volcker**. We did not think we were not putting our cards on the table. Lack of quantification has led to a great deal of confusion which is very unfortunate; I understand. The card on the table is that we want to work toward some reduction in the rate of growth of the money supply.

To the extent the budget moves out of balance and into deficit because it's reflecting a weak economy, it does not raise the kind of question that I was talking about in terms of deficits generally. That's a reflex in the economy that, of course, leads to further Government borrowing, and in some sense impacts on interest rates, but, in effect, it's a case of the Government deficit coming in to replace private credit demands that are weak during that kind of period; you have got the demand for money declining because the economy is weak. So, as we have seen, we've got a big deficit now, but we've had a very rapid reduction in interest rates as the economy declines.

That reduction in interest rates itself is part of the self-correcting mechanism in the economy, and I think you're beginning to see some of the implications, so when you speak of the deficit and what's going on during the recession, that automatic response is in somewhat of a separate category. But when you talk about moving beyond that into positive stimulus so-called——

PROJECTED INTEREST RATES FOR 1981

Senator **CHILES**. But assume we can't hold the line on that and we don't move into a positive stimulus in 1981, or even give me a scenario if we use it, the $25 billion tax cut. I would even like to know the difference. Can you give me some idea of how you see the interest rates; are they going to go up sharply after the election; will they be considerably higher next year?

Everyone says, as you know, that we've managed to get the interest rates down, or that we always get them down before an election. I've heard that so many times——

Mr. **VOLCKER**. Let me answer the question this way.

We have got a long-term rate of interest now for private securities in the 11-percent area for good bonds, the 12-percent area or a little more for mortgages. We have an underlying inflation rate, in my judgment, kind of a core rate determined by wages and productivity, in the 9- to 10-percent area. On an historical basis, that relationship between long-term interest rates and the underlying inflation rate—what people believe to be the underlying inflation rate—is not abnormal.

If we could go into recovery, and for quite a prolonged period of recovery, with some sense that that inflation rate was going down rather than up, I don't see anything inherent in recovery that would bring up long-term interest rates. In fact, depending upon what progress people felt was being made on inflation, recovery could be consistent with the decline of rates.

How you achieve that is the question. The market is going to take some convincing. We have made some progress; I think the extreme fears are gone—not gone, but latent—they could come back very easily. But the sensitivity and the concern that that inflation rate will go up rather than down is very real. I think you can understand there is hesitancy about whether a bond at current levels is a good buy if people think the inflation rate is going to go up. I think that's the challenge.

I'm just giving you the other side of the story. If you embark on recovery and it appears that the inflation rate is going to be shooting up again and we return to fears of a much higher rate of inflation, that is the worst possible environment for long-term interest rates.

ECONOMIC RECOVERY VIEWED PESSIMISTICALLY BY FINANCIAL COMMUNITY

Chairman **HOLLINGS**. Then let's put it generally. Mr. Volcker, why the pessimism then, of all the financial experts, where everybody talks about a slow recovery in 1981. My colleague here, he sees a faster recovery. They have housing starts, they've got a lot of good indications. The automobile, the small car will be coming out here. I'm listening on TV where everything is going to be much brighter.

But why is the financial community itself always talking about slow recovery, weak recovery? Why are they all talking in those terms and don't even give it a chance of any optimism?

Mr. **VOLCKER**. I don't have the impression right now they're all talking in quite those terms. I think the financial community is extremely sensitive, and maybe overly sensitive, but it is a fact of life that they're skeptical of everybody's credibility, concerned about the inflation rate increasing very markedly as soon as the economy turns around. They say if that happens it's bad for financial markets, therefore we don't believe in recovery. That is one line of argument.

Chairman **Hollings**. And the inherent suspicion of the politicians, the Government here in Washington, that as soon as it's all over and we have held the line long enough, and can all get reelected or whatever, then we'll go back to our——

Mr. **Volcker**. That's right. They've had 15 years to get sensitized to higher rates of inflation, and they are sensitized. That is the reason there is no good answer. There is no way anybody can say, "Look, I'm going to cure that unemployment rate next year," and, at the same time, with great assurance, say, "And will have no inflation." There isn't enough confidence out there that you can do it. The lack of confidence itself affects the behavior of markets, so that confidence has to be rebuilt.

PRESSURE INCREASING FOR MORE STIMULATIVE FISCAL POLICY

Senator **Bellmon**. Mr. Chairman, you haven't been through our hearings, obviously, but one witness after another has come in here and told us in 1981 we're going to have 8.5- to 9-percent unemployment and that the deficits are going to be $60 billion for 1980 and perhaps $30 to $50 billion for 1981. Some have told us this doesn't make any difference as far as the rate of inflation is concerned and that all we can do is sort of hunker down and live with these high unemployment rates.

Now, if you look at what's happened, the Federal Reserve set a firm course in terms of money supply growth, and the interest rates have fallen to almost one-half their April peaks in spite of our economy being weaker. Only once before in the post-war period have interest rates declined in the first months of a recession.

I'm not an economist, but I tend to be more optimistic. You need to give us, give me, and perhaps our Chairman, some reason, some basis for our resisting the pressures that are going to grow and I think become almost irresistable here, to either launch big new spending programs, or get ready for a tax cut. So far we haven't gotten any help out of any of our witnesses. In fact, the witnesses have all sort of reinforced the case of those who want a more stimulative fiscal policy.

Mr. **Volcker**. I have a certain personal resistance to giving economic forecasts because, as I said earlier, I am mainly impressed with how uncertain any economic forecast is these days.

The current indications are not totally pessimistic in that respect. I don't want to put a lot of weight on 1 month's increase in housing; I don't want to put a lot of weight on the fact that automobile sales apparently are going to be a bit higher in July, or at least they were in the first 20 days, and that June was a little higher than May. Retail sales also went up in June according to the preliminary figure, but that preliminary figure is subject to almost as many revisions as our money supply figures—more, I think. I may come up with a revised figure that shows it wasn't there. This is a collection of numbers that says you cannot ignore the possibility that this economy is going to level off pretty quickly. I think there are a lot of reasons to think that the recovery isn't going to be enormously vigorous.

We have got consumer debt down. There has been a remarkable contraction in consumer debt, going along with a remarkable contraction in consumer spending. When you look at those figures there's a positive side to it. The debt ratios have already declined from the peak levels that they had reached; whether they have declined as much as they're going to decline, I don't know. But in a relatively short period of time, in a very brief period of time, the consumer is in somewhat better financial position. Corporations have done quite a lot to improve their financial position, but that's going to take time. You can see forces at work consistent with bottoming out and recovery in the natural course of events.

STIMULATIVE FISCAL POLICY CURRENTLY UNNECESSARY

Senator BELLMON. Then your conclusion is that the Congress does not need at this time to adopt a stimulative fiscal policy; is that right?

Mr. VOLCKER. I don't think you should at this time.

Senator BELLMON. You think it would be wrong?

Mr. VOLCKER. I think it would be wrong to make that judgment now. I think it's conceivable, if everything goes the right way, I might have a different judgment at the end of the year, say, but I can't make that judgment now.

SOCIAL SECURITY PAYROLL TAX REDUCTION

Senator BELLMON. I want to get to sort of one specific question and then I'll get back to the general theme for just a couple more questions.

You have singled out depreciation as an important way that we could effect business costs and investment. Do you regard the social security payroll tax reduction in the same light?

Mr. VOLCKER. The payroll tax increase puts an additional burden on all of us, I think, in the sense of contributing to inflation. I have looked at that and looked at it again in terms of my own feeling, and I guess I come down on the bottom line that the basic linkage between the payroll tax and social security benefits is a good and logical linkage. However much I would like to see that social security tax reduced, I personally would not like to see the linkage broken. That's a matter of philosophy, I suppose.

If I look at it from the economic policy and inflation standpoint, I think it would be very helpful, if any tax action were going to be taken, to deal with the social security increase, but I cannot personally get over that concern, when the social security trust fund is potentially running out of money, over breaking the link between the two.

Senator BELLMON. Well, I don't want to try to pin you down to specific tax policies. But I agree with you. I think it would be a political disaster if we ever unhitched social security and the payroll tax, because then politically there will be pressure to keep increasing benefits and no offsetting pressures from those who have to pay the cost.

Mr. VOLCKER. The temptation is very great, because it does have a direct impact on costs and prices.

INFLATIONARY RESULT OF STIMULATIVE POLICY

Senator BELLMON. We might see something like medicare taken out of the social security fund.

If we in Congress do go ahead and adopt a stimulative policy, whether it's an increase in spending or a tax cut, could you—assuming it amounts to say the $30–$40 billion dollar range—what would you anticipate to be the first inflationary result and what would the increase in interest rates likely be?

Mr. VOLCKER. I can't judge the amount, but if Congress enacted that kind of a tax program tomorrow, I believe the immediate impact on the financial markets, long before the tax cut ever went into effect, would be adverse.

Senator BELLMON. Adverse?

Mr. VOLCKER. Adverse.

Senator BELLMON. And the result then would be another spurt of inflation and——

Mr. VOLCKER. The fear would be of inflationary pressures. I'm now talking about a psychological reaction. When the tax cut actually went into effect, it would, of course, add directly to Government borrowing demands and to the degree it stimulated the economy, it might or might not add to inflation. I can't judge what the economic conditions will be at that time. The ultimate answer would depend upon what will the economic conditions be.

I think the fundamental underlying case for a tax reduction is very strong, but I just don't share the feeling that just because we would like to see a tax reduction—a good, sound reason for a tax reduction—we can ignore the setting and the budgetary consequences; it may end up that those great benefits from tax reduction are lost in the adverse repercussions.

FACTORS FOR ECONOMIC RECOVERY

Senator BELLMON. One last question. You said the Fed intends to follow—I think your term was a restrictive growth in money supply for the foreseeable future——

Mr. VOLCKER. Restrained growth; yes.

Senator BELLMON. Restrained growth. OK.

We hear about restrained fiscal policy. What then will drive the economy toward recovery?

Mr. VOLCKER. Some of the factors that I alluded to, where you can see some signs now, however inconclusive. The consumer is getting in better shape; business balance sheets are getting in better shape; the automatic stabilizers are working in full force. From the budgetary side, we have a much more favorable credit climate and borrowing climate than, obviously, we have had for several years. All of those conditions support and reinforce the natural recuperative powers of the economy.

Senator BELLMON. If it turns out that your assumptions—and I might say that I share you feeling, that the economy is going to strengthen—but assuming we're wrong, will the Fed then follow a different course?

Mr. VOLCKER. No. I don't know what's right or wrong here, but if the pessimists are proved right and we have a kind of secondary dip in the economy, and plant and equipment turns sour, and we have a large inventory adjustment and all the rest of the things that some people fear—and I understand those concerns—if that all happens, you would naturally expect interest rates to go lower because of the balance of supply and demand in the credit markets. In that case, I think stimulating fiscal action would be greater. At some point the nature of economic conditions would strengthen that case. But that's my point; that's another thing you want to look at. I don't think we can say that now. If we're wrong, as you put it, and the economy is in much weaker condition at the end of the year, the case for moving and cutting taxes is improved.

Chairman HOLLINGS. Senator Metzenbaum.

IMPROVED CONSUMER CIRCUMSTANCES

Senator METZENBAUM. Mr. Volcker, I just heard you say the consumer is getting in better shape. He hasn't told me about it. Tell me about it.

Mr. VOLCKER. He's actually feeling a little better, according to the surveys. But he was feeling very badly a few months ago. The most recent surveys say he's feeling a little better about the future.

I think we have seen the sharpest decline in installment credit—all types of consumer credit outstanding—that we have had during the post-war period. Incomes have continued to go up at a slower rate of speed, but in nominal terms, not real terms, incomes are going up.

Senator METZENBAUM. But below the inflation rate.

Mr. VOLCKER. Below the inflation rate.

CONSUMER WAGE ADJUSTMENTS FALLING BEHIND COST-OF-LIVING

Senator METZENBAUM. So the consumer is literally not getting in better shape. He may think he is, but the fact is that his salary or wage adjustments are falling behind the rise in the cost of living.

Mr. VOLCKER. In June, or whatever 1 month's figure is worth, he actually had an increase in real income. But for some time, for a year or 18 months or 2 years, income per capita has been going up, less rapidly than the Consumer Price Index. In that sense he's worse off, that's right.

Senator METZENBAUM. He's worse off.

Mr. VOLCKER. He's worse off, in that the average individual has lost real income.

It's terribly important to understand why that's the case. It's the case for two reasons. In the long run, real income only comes from productivity, and in this recent period productivity has been declining, not rising. On top of that, of course, we had oil price increases imposed upon the consumer, and he has lost income because of the external shock of the oil price increase. He's lost real income because of the oil price increases and because of the decline in productivity.

Senator METZENBAUM. Dr. Volcker——

Mr. VOLCKER. That was true even when the economy was expanding.

OIL COMPANY PROFITS AND OPEC PRICE INCREASES SHARE BLAME FOR RISING INFLATION

Senator **Metzenbaum**. Dr. Volcker, I just want to say that you and some others would like to blame much of the inflationary rise on the OPEC countries. Realistically speaking, a major portion of that has to be shared due to the fact of the unwarranted profit increases that the oil companies have used to exploit the situation; isn't that the fact?

Mr. **Volcker**. I don't blame that much of our total inflation on the oil situation. That has been a serious contributing factor, and it was certainly a very big factor in 1974 and again late last year. But our fundamental inflation problem is not the oil price increase, in my judgment.

Senator **Metzenbaum**. Well, it was adding about 35 percent directly and about 50 percent indirectly to the inflation index when it was running at an 18 percent rate.

Mr. **Volcker**. At those periods it was a major share—say last December, January, February, March and in 1974. When one looks at the whole sweep of the past decade, it's significant, but I don't think we can say our inflation was caused by that.

Senator **Metzenbaum**. Let me get to my real concerns—go ahead, I'm sorry.

Mr. **Volcker**. You referred to the profits of the oil companies. I am one step further removed, in a sense. I'm not blaming the whole inflation by a long shot on oil, and even less on oil company profits.

THE DESPERATE PLIGHT OF THE POOR AND THE UNEMPLOYED

Senator **Metzenbaum**. Dr. Volcker, I just came from a hearing this morning, where a husband and wife were testifying. He's been out of work a year, up near Detroit—a young couple, two children. He works for an auto manufacturer, and she worked for Ford. She's out of work, too.

They have no money. They have no food. After she became out of work, she said she took a job in a drug store at $2 an hour. She lost that job. She said this morning she would take even $1 an hour to put some food on her table for her kids.

Another witness testified about the fact that she tries to run a hot line to help people find jobs, also near Detroit. She said that she had heard of a young 22-year-old man with a wife, one child 1-year-old, one child on the way. The father was in the hospital, a 22-year-old, for a nervous breakdown because he couldn't find a job and had no money to feed his family.

She went to the hospital to find him and found he had been expelled because he didn't have any hospitalization insurance. She then raised some money for him through the union. She ran with the money over to his home to give it to him, to help him along, to feed his family, but she met the mortician who was taking his body out of his house. He had hanged himself.

IMMEDIATE RELIEF NECESSARY

Now, I have heard you and every other economist come before this committee within the last several days—I haven't heard every one of them, but I don't think any of them have spoken differently—and all I've heard about the economy is that we have to have tax reduction, we need 10-5-3 or something similar thereto. You just said we need production incentives. That's the new flag around which we must all rally. We've got to balance the budget. We have to have tight money policies. We have to restrain growth and money supply. We have to have fiscal responsibility.

But neither you, as I understand it—and I haven't read your entire testimony. I wasn't here for all of it, I'm sorry to say—but neither you nor any of the others have talked about how we go about feeding the people who are hungry today; what do we do about the almost 9 million Americans who can't find a job and want one; what do we do about educating our kids and sheltering them. All I hear is what we're going to do with some of these terms.

There aren't 3 percent of the people in this country who know what they mean. They understand what tax reduction is. They don't know what 10-5-3 is. They don't know what production incentives are. They couldn't care less about balancing the budget. They don't understand tight money. They don't understand fiscal responsibility, and they don't understand restrained growth and money supply. But they do know what it means to try to pay to feed the family and to clothe the family and educate them and to house them.

They are losing their homes, and all that I hear the Federal Reserve Board advocating, all that I heard these other very, very profound economists advocate, is something to provide production incentives.

My question to you, Dr. Volcker, is what do I say to the people of Ohio about what all of these things are going to do now, or doesn't this Government have some responsibility to do something about the unemployment that exists and the people who are hungry in America today.

LONG-TERM CURE ONLY ANSWER

Mr. VOLCKER. I think the Government has the responsibility to make this economy perform as effectively as it can to create job opportunities for the people that you're talking about, that everyone has to be concerned about that.

The only debate, if that's the right word, that we are engaged in is how to do that in a way that is truly constructive. I think it's a cruel joke, so to speak, on these people to pretend that we can take action that seems to be in some immediate sense directed toward their needs, and to find out next year that we've got more people who are in need. We have launched the economy on a course that makes it almost inevitable that this episode will be repeated, and perhaps in worse form. I think there has been a little bit of that in governmental——

Senator METZENBAUM. How can it be worse for a person who's hungry? How can it be worse than that?

Mr. VOLCKER. There can be more hungry people.

Senator **Metzenbaum**. Are there going to be more people? All the economists told us there are going to be more people.

Mr. **Volcker**. Nobody is going to argue that we're not in a most serious and grave and unfortunate problem now. The question is how do we get out of this in a way that is truly constructive over a period of time. I think that's all the debate is about, and it gets bogged down in technicalities.

Senator **Metzenbaum**. But what do we do with the problem? You say it will be worse if we provide CETA jobs, if we provide more food stamps, if we provide more job programs, it will be worse. Can it be any worse than when people are hanging themselves because they don't have food for their family? The woman didn't make up her story.

Mr. **Volcker**. I'm not suggesting she made up her story. I am suggesting that, unfortunately, I can imagine still worse economic situations than what we have. What we have is bad enough. Our policy ought to be directed toward a course which minimizes the chance of a recurrence of what we now have.

QUICK FIX HAS BAD RECORD

Senator **Metzenbaum**. In every other recession, hasn't the Government attempted to move in and provide some amelioration of the problem? They haven't just talked about production incentives that may cause factories to start work in a year or two from now, and maybe doing something about——

Mr. **Volcker**. I think that's broadly true. What is the record of the past 15 or 20 years? The Government has always stepped in and attempted to deal with these things in a certain way by stimulating purchasing power or whatever. The record of the last 15 years is quite unambiguous: we get bigger recessions than we had before and we have more inflation. You have to begin asking yourself whether what we did over these 15 years was right or wrong. Somehow we ended up in 1980 with a bigger recession than we had in the 1960's; we ended up with more inflation. You have to ask yourself whether there is some connection between those two events, so that we don't end up in 1990 with still more.

FEDERAL RESERVE POLICY EXACERBATED RECESSION

Senator **Metzenbaum**. Isn't it the fact that many are claiming that one of the reasons of the recession being as bad as it is is because of the very policies that the Fed has followed?

Mr. **Volcker**. I know some people say that. I don't happen to believe it, but that's——

Senator **Metzenbaum**. I wouldn't expect you would. But the fact is, that there seems to be certainly a substantial block of people who feel that way.

What I'm concerned about is that the Fed is great in talking about tight money, restrained growth, fiscal responsibility, balance the budget, and so on. Great. We'll balance the budget. That's the greatest thing in the world. We balanced the budget and spent months and months working on it. We put $7 billion more into the defense budget, 14 of it including the original amount. We then went around and cut everybody back: food stamps, this program and that program. Got it all done and balanced the budget, and then you had help to increase unemployment—and we're still $30 billion out of balance at the moment.

So all that work was to no avail. Now maybe isn't it time for a new perspective. Are you really solving anything, or are you just trying to do something about the viability of the economy generally but not worried really about the people who make up this Nation of ours?

Mr. **Volcker.** If I knew some way to get that unemployment rate down next month as low as you want to make it, and I thought that could be successful, and I thought it wasn't going to create worse problems in the future, I would obviously do it.

PRESENT POLICY PROVIDES NO HOPE

Senator **Metzenbaum.** Let me ask you another question.

Ten or fifteen years ago I came to Washington, and a group of businessmen, labor leaders, Government officials, and the whole nation was panicky because we had so much unemployment in the country and so many problems that they were burning down Watts and they were burning down Detroit, burning down Hough in Cleveland, burning down Washington, and they were burning down Gary, Ind.

The urban coalition was formed out here at the Sheridan Park, and we made up our mind we were going to solve the problem before America was totally burned down. Now there's no urban coalition that I know of. Now there's really no impetus to provide jobs and to solve the problem. But all I hear day in and day out is production incentives, 10-5-3 tax incentives, that and a great hope, but it provides no hope for Americans who are the have nots.

Mr. **Volcker.** It's important that we have hope. It's important that we have confidence as we look ahead. I think it's important we learn the lessons from the past.

You referred to the family in Detroit. Apparently both members were working in the automobile industry and have been laid off from the automobile industry. But it's at least relevant, I think, to ask the question as to what happened to the automobile industry, and why are they in that situation? Have they had enough production incentives in the past? Have those that have worked made that industry more competitive or less competitive over a period of time?

The industry is obviously having competitive problems. Has management made the right kind of judgments in the past? Has public policy induced them to adapt to the new environment? Those are the kinds of questions that I think we have to ask today so that we don't face the situation, either in the automobile industry or airline industry or any industry in the future.

PRODUCTION INCENTIVE NOT CAUSE OF AUTO BUST

Senator **Metzenbaum.** Isn't it a fact, Dr. Volcker, that the auto industry isn't in trouble because of a lack of production incentive. The auto industry is in trouble because the leadership of the auto industry was determined they were going to sell big cars; they weren't worried about the gas guzzlers. They fought those of us in the Congress, Senator Jackson and myself and others, who put through legislation to require higher gas mileage, and they killed the bill in the House. They were indifferent to that need to build automobiles that got better gasoline mileage. And the people turned away from them.

Mr. **Volcker**. I certainly think that is one very considerable fact. But let us say, even in that case, from the standpoint of the automobile manufacturers, until very recently they were faced with a big demand for big cars and very little demand for little cars, because the Congress really didn't give the consumer much of an incentive to go for little cars until recently; OPEC has given them the incentives.

Senator **Metzenbaum**. I don't consider it an incentive just to increase prices on the consumer. That's not an incentive. That's a disincentive.

I yield. Thank you very much.

THE HUNGRY BEING SOUGHT AFTER, BUT——

Chairman **Hollings**. We appreciate it very much.

The fact of the matter is, I guess I know as well as any the gap between the Government provisions and services and the actual receipt thereof, and it is unfortunate anybody is starving because we put a cap on food stamps at—it was $6 billion in 1978, and we got it up to $12 billion. It's not on account of the starving. It's on account of the person who is making $10,000 a year.

We have trade adjustment assistance, and we gave every bit requested, and we are increasing that as part of our increased 1980 deficit for balanced budgets and everything else. There is additional trade adjustment assistance, additional food stamps, additional feeding programs. So as we struggle to balance the budget, and as we struggle to get productivity incentives, we are also struggling against certain urban coalition programs. They have all been tried and we find ourselves in the same position all over again, namely, the countercyclical, the public works jobs and everything else. We can list them all.

I'm like you. I want to get to the hungry person. Nobody wants anybody starving.

Senator **Metzenbaum**. I want to say one of these people testified this morning that they couldn't get welfare because they said "you're going to get trade, your TRA benefits". But the fact is we haven't passed that, and you can't get it at the moment. We need to pass legislation, and I think there will be some opposition to it before we get it through on the floor of the Senate.

I think that's an accurate reflection of the situation that exists. At this moment we need to pass legislation on that subject.

Chairman **Hollings**. There's an existing program of trade adjustment assistance. The expansion of it has been held up. We put in a supplemental for trade adjustment assistance.

Senator **Metzenbaum**. That is correct. But——

Chairman **Hollings**. In fact, one of the complaints—and we have had this in hearings, whereby the laid-off automobile worker is receiving on the one hand the unemployment compensation, and on the other hand trade adjustment assistance. "Look, I'm making a little bit more than what I was making down at the Ford plant, so I'm not worried about getting back to work." That was one of the things we were having to consider.

Dr. Volcker, you have been very helpful and we appreciate it very, very much.

CONGRESS RIGHT, BUSINESS WRONG

Let me just correct one thing about that group in Detroit. I had hearings—our oil friends are most effective. They not only did away with all the controls and everything else, now we've got an $80 billion additional inflation this year. But the automobile friends totally stonewalled the fuel economy car. I had all of those hearings, and I happened to be there in the markup of what we called the Fuel and Policy Conservation Act of 1975, and we had to compromise it downward in order to have it included.

I think the gentlemen's names were Carter from Chrysler, who stonewalled and said I was a crazy so and so, and had the decency to come by and say, "Look, I want to improve upon it, and our misfortune was that we didn't see it as you saw it and we only were able to get 300,000 Volkswagen engines into our Horizons and our Omnis." And I think Murphy of General Motors finally said that was one place where the Congress was right and business was wrong.

We tried in the early seventies. We shoved, we pushed, we cajoled, and they stonewalled, stonewalled, stonewalled. The whole mechanism was the bigger the car, the bigger the profits. So now they are somewhat caught up.

I'm not trying to win that particular point. I would try to give them some kind of protection, momentarily, until an orderly marketing agreement is worked out. Even Margaret Thatcher and the British helped their automobile industry over a 12- to 18-month period. And while we're retooling for it, I think the Government can do something about that industry, even though in this particular instance it was private free enterprise that was wrong and Government that was right. But that's just my own comment. I take the liberty as chairman.

Mr. VOLCKER. I understand your point entirely. My only point was I think it is fair to say the market incentives at that time were working in the opposite direction, because the gas price was actually declining in real terms and the American consumer was, in effect, on their side; they were both on the wrong side.

Chairman HOLLINGS. Well, we've got another rollcall. This would be a good time to break.

We appreciate your appearing here this morning.

Mr. VOLCKER. Thank you, Mr. Chairman.

[Whereupon, at 12:10 p.m., the Committee was adjourned.]

[From the New York Times, June 30, 1980]

$100 BILLION IS FOUND APPROVED BUT UNUSED IN PUBLIC WORKS PLANS

(By John Herbers)

WASHINGTON, June 29—While Congress considers providing more money for public works projects to offset the effects of the recession, an estimated $100 billion already appropriated by Federal, state and local governments for such construction remains unused because of tangled procedures.

The estimate was made by Pat Choate, an economist and former Government official who is the author of a new study on how delay in construction, particularly in the public sector, has increased sharply in recent years. An official of the Federal

Office of Management and Budget said he agreed with the overall findings of the study.

Because it takes so long for public works money to be spent, studies by Mr. Choate and others indicate, such appropriations are an ineffective tool for stimulating the economy in a recession.

"Instead of considering whether to appropriate a couple of billion dollars for new projects," Mr. Choate said in an interview, "it would be much easier and more effective to find ways to speed up spending of some of the $100 billion clogged in the pipelines."

The existence of this enormous backlog, less than half of which is in state and local public works programs, is not widely known, and pressures have been growing in Congress for a new appropriation for "accelerated" public works spending.

The Carter White House has been reported by both congressional and Administration sources to have agreed to a new $2 billion local public works program, which it previously opposed, as the price of obtaining from Congress urban economic development funds under a separate program.

The agreement was made although a study by the Office of Management and Budget, an arm of the Presidency, had shown that emergency public works programs had produced only limited impact on a depressed economy. The last such program, totaling $6 billion, was designed for the recession that was at its worst in early 1975. But the bulk of the money was not spent until 1978, when the economy was entering an inflationary period, and was thus counterproductive.

Anthony J. Sulvetta, who prepared the O.M.B. study, said this was true even though the agency involved, the Economic Development Administration, had made an extraordinary effort in distributing the money and getting projects started. Ten percent of the $6 billion still has not been spent.

It was Mr. Sulvetta who said he agreed with the overall findings of the Choate study.

Mr. Choate, a former administrator of several Federal and state programs and now a visiting fellow at the Academy for Contemporary Problems, found that the delays in public works programs were damaging to the economy in other ways. They have increased inflation, lowered productivity, raised the cost of construction and tied up capital funds in unproductive uses, he said.

Governments do not set aside appropriated funds; when the recipients are ready to spend it, the money is borrowed or taken from tax revenues. But it is available at any time after the paperwork for a project is completed.

ACTION WITHOUT DEADLINES

The chief cause of delay, Mr. Choate said, is a fragmented system of government proceeding without deadlines against a complex array of regulations and procedures.

"The Federal Government is being held hostage to the incompetence or inability of state and local governments to expedite procedures," he said. "At the same time, the state and local governments are being held hostage to all the regulations of the Federal Government. If one were to design a system to achieve the maximum amount of delay, this is it."

What is needed, he said, is a national strategy that would include the setting of time limits on projects. He said he was convinced that the deadlines could be met and still comply with all the environmental and other requirements.

In his study for the academy, a nonprofit research organization set up to assist state and local governments, Mr. Choate found that in just one program, the Community Development Block Grant Program, established in 1974 to assist cities and counties, more than $18.6 billion had been appropriated. But at the beginning of this year, $6.2 billion remained in the Treasury.

DIFFERENCES IN USE BY CITIES

The backlog apparently has no relation to need. New York and Chicago have drawn only 54 percent each of their block grant funds. In the case of New York, $808 million remains in the Federal Treasury.

Baltimore, on the other hand, has used 88 percent of its funds, which suggests that that city has found a way to overcome the maze of regulations and conflicts between various levels of government.

Similar delays were reported in funds appropriated for local projects through the Environmental Protection Agency, the Economic Development Administration and other agencies. Delay has cost the Tennessee Valley Authority $10 billion, dating to the 1960's, because of extremely long periods of construction of generating plants, Mr. Choate said.

The Environmental Protection Agency has a $9 billion backlog, the Department of Housing and Urban Development $6 billion and the Farmers Home Administration $2.3 billion to $3 billion.

"It adds up in a hurry," Mr. Choate said. "The $100 billion is a very conservative estimate."

Public construction on all levels totals about $45 billion a year, Mr. Choate said. There has always been a lag between appropriation and expenditure. But in recent years the average time lag has increased rapidly.

How delay works can be seen in the Economic Development Administration. At the end of the first quarter of the fiscal year 1980, Mr. Choate said, the agency had distributed only 4.2 percent of its funds for the fiscal year 1979, "even though the agency had access to those funds for more than 15 months." Of its 1978 funds, 65 percent was unspent. Money was left from other years as well, including 8 percent of the 1974 funds.

In one instance, the agency allotted $10 million for an industrial park in 1974, but several other Federal, state and local agencies had to give their approval before work could get underway. The project then became the subject of studies, red tape, disputes and confusion that continued until the cost had risen to $15 million, requiring further applications for additional funds—which also have not been spent.

In many instances, Mr. Choate said, because of political pressures, projects are approved and financed before they have been properly planned.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

FOR RELEASE AT 2:00 P.M. (E.D.T.)
Monday, July 21, 1980

MID-SESSION REVIEW OF THE 1981 BUDGET

TABLE OF CONTENTS

Page

INTRODUCTION.. 1

PART 1. THE CURRENT BUDGET OUTLOOK, 1980-1981.............. 3
  Budget Totals.. 3
  Short-Range Economic Forecast.............................. 5
  The Effect of Recessions on the Budget..................... 8
  Budget Receipts.. 9
  Budget Outlays... 11
  Budget Authority... 13
  The Credit Budget.. 15
  Off-Budget Federal Entities................................ 17
  Comparison of Administration and Budget Resolution Totals.. 18
  Summary Tables... 22

PART 2. CHANGES IN BUDGET AUTHORITY AND OUTLAYS BY FUNCTION, 1980-1981............................ 33

PART 3. LONG-RANGE BUDGET OUTLOOK.......................... 61
  Long-Range Economic Assumptions and the Budget Outlook... 61
    Long-Range Economic Goals.............................. 61
    Basic Assumptions...................................... 62
    Budget Projections Under Humphrey-Hawkins Goals...... 62
    Budget Projections Under Alternative Economic Assumptions.. 64
    Projections of Outlays for Open-Ended Programs and Fixed Costs.................................... 65
    Spending from Balances of Budget Authority at the End of Fiscal Year 1981: Non-Mandatory Programs.... 66
  Summary Tables... 67

GENERAL NOTES

1. All years referred to are fiscal years unless otherwise noted.

2. Detail may not add to totals due to rounding.

LIST OF TABLES

Page

PART 1. THE CURRENT BUDGET OUTLOOK, 1980-1981

1. Budget Totals.. 3
2. Short-Range Economic Forecast.......................... 6
3. Budget Totals in Recessions............................ 8
4. Change in Budget Receipts, 1980 and 1981............... 10
5. Change in Budget Outlays, 1980 and 1981................ 12
6. Change in Budget Authority, 1980 and 1981.............. 14
7. Change in the Credit Budget Totals, 1980 and 1981...... 15
8. Change in the Credit Budget Totals Since March......... 16
9. Change in Outlays of Off-Budget Federal Entities, 1980 and 1981.. 17
10. Administration and Budget Resolution Totals........... 18
11. Budget Receipts by Major Source, 1979-1981............ 22
12. Budget Outlays by Function, 1979-1981................. 23
13. Budget Outlays by Agency, 1979-1981................... 24
14. Budget Authority by Function, 1979-1981............... 25
15. Budget Authority by Agency, 1979-1981................. 26
16. Budget Surplus or Deficit (-) by Fund Group and Type of Transaction, 1979-1981.................. 27
17. Budget Receipts and Outlays by Fund Group, 1979-1981 28
18. Debt Subject to Limit, 1979-1981...................... 29
19. The Credit Budget Totals, 1979-1981................... 30
20. New Direct Loan Obligations by Agency, 1979-1981...... 31
21. New Loan Guarantee Commitments by Agency, 1979-1981.. 32

PART 2. CHANGES IN BUDGET AUTHORITY AND OUTLAYS BY FUNCTION, 1980-1981

--- Changes in Budget Authority and Outlays for Each Function, 1979-1981................................ 33-59

PART 3. LONG-RANGE BUDGET OUTLOOK

22. Comparison of Long-Range Economic Assumptions, 1982-1985.. 62
23. The Budget Outlook Under Humphrey-Hawkins Goals, 1981-1985.. 63
24. Budget Receipts and Outlays Under Humphrey-Hawkins Goals, 1981-1985....................................... 63
25. The Budget Outlook Under Alternative Economic Assumptions, 1981-1985.............................. 64

Page

PART 3. LONG-RANGE BUDGET OUTLOOK (continued)

26. Differences in Budget Projections Under Humphrey-Hawkins and Alternative Economic Assumptions, 1981-1985 65
27. Long-Range Economic Assumptions under Humphrey-Hawkins Goals, 1982-1985 67
28. Alternative Long-Range Economic Assumptions, 1982-1985 69
29. Budget Receipts by Major Source, 1979-1985 71
30. Estimated Effect of Administrative Actions and Proposed Legislation on Receipts, 1980-1985 72
31. Composition of Budget Outlays, 1979-1985 73
32. Budget Outlays by Function, 1979-1985 75
33. Budget Outlays by Agency, 1979-1985 76
34. Budget Authority by Function, 1979-1985 77
35. Budget Authority by Agency, 1979-1985 78
36. Projections of Outlays for Open-Ended Programs and Fixed Costs, 1981-1985 79
37. Estimated Spending from the End of Fiscal Year 1981 Balances of Budget Authority: Non-Mandatory Programs 80

INTRODUCTION

This Mid-Session Review provides revised estimates of the 1981 budget as required by Section 201 of the Budget and Accounting Act. These estimates take into account completed congressional action, including the Supplemental Appropriations and Rescission Act that was signed by the President on July 8, 1980, recent experience on the rate of spending for Federal programs, and revised economic assumptions. The Review also provides estimates and projections for the 1982-1985 period and other information required by law.

At the beginning of the calendar year, the economic situation was characterized by rapidly rising inflation and interest rates. Although inflation continues to be unacceptably high, it has slowed dramatically from the first quarter, and should drop further in the months ahead. The unemployment rate, which reached 7-3/4% in June, is now expected to rise to 8.5% by the last quarter of the year.

In response to the sharp rise in inflation, inflationary expectations, and interest rates early in the year, the President submitted budget revisions to the Congress in March that reduced outlays for 1981 by $17.2 billion. These reductions were the product of lengthy consultations between the President, his senior advisers, and the leadership of the Congress. The policy of budget stringency that was agreed to then is being continued in this Mid-Session Review to help restrain inflation. The Review proposes no new spending initiatives. The changes shown in this Review, which are substantial, result from:

-- the revised economic outlook;

-- unanticipated events such as the eruptions of Mount Saint Helens, and the recent heavy influx of Cuban/Haitian entrants;

-- changes in the spendout of major procurement and construction programs, notably defense; and

-- other minor revisions.

Congressional responses to the President's proposals for budget restraint have been constructive. Although the Administration does not agree in detail with all of the actions taken by the Congress, congressional action to date on the 1981 budget is consistent with the President's policy of fiscal stringency. This year the Congress has modified its own budget action to include a reconciliation bill as part of the first concurrent resolution. The Senate has already acted on this measure, reducing 1981 budget authority by $4.0 billion and outlays by $5.2 billion. The Administration looks forward to prompt, similar action on the part of the House of Representatives. Enactment of such a reconciliation bill will be a significant milestone in the continuing efforts by the Congress and the Administration to maintain appropriate budgetary discipline.

This Review provides revisions of the Administration's budget estimates as required by law. It does not propose policy changes. Policy measures to increase investment, productivity, and economic growth -- with beneficial effects on unemployment and inflation in 1981 and later years -- will be developed carefully in close consultation with the Congress and others in the months ahead.

It is quite likely that a tax cut will be desirable in 1981. But it is not appropriate to propose one now. The Administration believes strongly that the last months of a congressional session, in an election year, are not the best time to make the judicious decisions needed for a skillfully designed tax program to improve economic performance.

Part 1

THE CURRENT BUDGET OUTLOOK, 1980-1981

Budget Totals

The revised 1980 and 1981 estimates in this review reflect:

- policy changes enacted by the Congress since the January budget and March revisions were issued;
- reestimates of receipts and outlays in light of revised economic assumptions and more recent data; and
- technical changes in many estimates.

The current estimates supersede the revised budget estimates published in March. Table 1 compares the current estimates with the Administration's January and March figures.

Table 1.--BUDGET TOTALS
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	Jan.	March	July	Jan.	March	July
Receipts.......	465.9	523.8	532.4	517.9	600.0	628.0	604.0
Outlays........	493.7	563.6	568.9	578.8	615.8	611.5	633.8
Deficit, current estimate...	-27.7	-39.8	-36.5	-60.9	-15.8	16.5	-29.8
Budget authority.....	556.7	654.0	655.8	653.7	696.1	691.3	707.2

The 1980 deficit is now estimated to be $61 billion, $24 billion above the March estimate. The current estimate for 1981 is for a deficit of $30 billion, rather than the $16.5 billion surplus estimated in March. Both the increase in the 1980 deficit and the shift from surplus to deficit in 1981 are the result of the following factors:

- Estimated receipts have declined by $15 billion in 1980 and $24 billion in 1981. These reductions are caused largely by lower incomes resulting from the recession and by congressional repeal of the President's gasoline conservation fee.
- Estimated outlays have increased by $10 billion in 1980 and $22 billion in 1981. These increases are largely attributable to higher costs for unemployment benefits and other programs due to the recession; higher costs of the defense program; and unavoidable increases in a number of programs resulting from natural disasters, the recent heavy influx of Cuban/Haitian entrants, and other events.

Short-Range Economic Forecast

The economy is experiencing a deeper recession than expected earlier this year. The rate of unemployment, which has reached 7-3/4% in the last two months, is likely to rise somewhat further during the final half of this year, reaching 8.5% for the final quarter. Economic recovery is expected to begin around the end of the year, but to proceed slowly during 1931 with unemployment remaining at about 8-1/2% in the absence of policy changes. We consider this an unacceptably high rate, and the Administration will therefore be working with the Congress to develop a program that will assist the economic recovery at the same time that it helps to achieve long-term economic goals.

Inflation as measured by the CPI is projected to moderate substantially from the high rates experienced during the first half of this year. Measured fourth quarter over fourth quarter, the CPI is projected to increase by 12% during 1980 and slightly less than 10% during 1981. About one-half percentage point of the 1981 CPI increase results from the motor fuels tax, which is proposed to become effective next spring. This tax remains necessary as a means of helping to reduce our Nation's energy consumption and dependence on foreign oil.

Table 2.-- SHORT-RANGE ECONOMIC FORECAST
(calendar years; dollar amounts in billions)

	Actual	Forecast	
	1979	1980	1981
Major Economic Indicators			
Gross national product (percent change, 4th quarter over 4th quarter):			
Current dollars	9.9	6.7	12.6
Constant (1972) dollars	1.0	-3.1	2.6
GNP deflator (percent change, 4th quarter over 4th quarter)	8.9	10.1	9.7
Consumer Price Index (percent change, 4th quarter over 4th quarter	12.8	12.0	9.8
Unemployment rate (percent, 4th quarter)	5.9	8.5	8.5
Annual Economic Assumptions			
Gross national product:			
Current dollars:			
Amount	2,369	2,557	2,821
Percent change, year over year	11.3	7.9	10.3
Constant (1972) dollars:			
Amount	1,432	1,412	1,416
Percent change, year over year	2.3	-1.4	0.3
Incomes:			
Personal income	1,924	2,103	2,327
Wages and salaries	1,228	1,327	1,459
Corporate profits	237	220	217
Price level:			
GNP deflator:			
Level (1972=100), annual average	165.5	181.1	199.2
Percent change, year over year	8.8	9.4	10.0
Consumer Price Index 1/:			
Level (1967=100), annual average	217.7	246.8	270.8
Percent change, year over year	11.4	13.4	9.7
Unemployment rates:			
Total, annual average	5.8	7.6	8.5
Insured, annual average 2/	3.0	4.4	5.0
Federal pay raise, October (percent) 3/	7.0	7.8 4/	9.0
Interest rate, 91-day Treasury bills (percent) 5/	10.0	9.2	9.0

See footnotes on following page.

Table 2 (continued)

1/ CPI for urban wage earners and clerical workers. Two versions of the CPI are now published; one for urban wage earners and clerical workers and one for all urban consumers. The index shown here is required by law to be used in calculating automatic cost-of-living increases for indexed Federal programs.

2/ This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.

3/ Pay raises become effective in October of each year -- the first month of the new fiscal year. Thus, the October 1980 pay raise will set new pay scales that will be in effect during fiscal year 1981.

4/ This is the projected pay increase for white collar workers and wage board employees. The pay raise for military personnel is estimated to be 9.1%.

5/ Average rate on new issues within period. These projections assume, by convention, that interest rates are linked to the rate of inflation. They do not represent a forecast of interest rates.

The Effect of Recessions on the Budget

Economic recessions have major effects on the budget, but the magnitude of these effects is not widely understood. During recessions receipts grow substantially more slowly as a result of lower income and payroll tax receipts that accompany lower GNP growth. At the same time, outlays for unemployment benefits and certain other programs grow more rapidly because of higher unemployment rates. These automatic responses of the budget to a recession combine to produce a substantial impact on the budget surplus or deficit. Furthermore, the dollar value of this effect tends to increase over time with normal growth in the size of the economy and the budget. For this reason, the effect of recessions on the budget is best understood in relation to the size of GNP.

The following table shows changes in the budget surplus or deficit during four previous postwar recessions. Growth rates of receipts and outlays in these years are also shown. During some recessions part of the lower growth in receipts was due to tax cuts, but the automatic effects referred to above were the major cause of changes in the deficit during all the recessions.

Viewed in this historical perspective, the rise in the budget deficit from $28 billion or 1.2% of GNP in 1979, to $61 billion or 2.4% of GNP in 1980 is consistent with the normal change in the budget deficit during recessions.

Table 3.--BUDGET TOTALS IN RECESSIONS
(dollar amounts in billions)

	Percentage Increase in		Deficit	
	Receipts	Outlays	Level	Percent of GNP
1957	7.3	8.9	3.2	0.8
1959	-0.5	11.5	-12.9	-2.7
Change			-16.1	-3.5
1960	16.7	0.1	0.3	0.1
1961	2.1	6.0	-3.4	-0.7
Change			-3.7	-0.8
1969	22.2	3.2	3.2	0.4
1971	-2.8	7.5	-23.0	-2.3
Change			-26.3	-2.6
1974	14.1	9.1	-4.7	-0.3
1976	6.9	12.3	-66.4	-4.1
Change			-61.7	-3.8

Budget Receipts

The current estimate of 1980 receipts is $517.9 billion, which is $14.5 billion below the March estimate and $5.9 billion below the estimate in the January budget. Receipts in 1981 are now estimated at $604.0 billion, which is $24.0 billion below the March estimate and $4.0 billion above the budget.

As shown in Table 4, policy changes and congressional action since March have reduced receipts by $4.3 billion in 1980 and $8.4 billion in 1981. These changes include:

-- Congressional repeal of a temporary fee of $4.62 per barrel on imported crude oil. This fee was to have been shifted entirely to the production of gasoline.

-- A delay in the effective date of the proposed gasoline and diesel fuels tax, from October 1, 1980 to June 1, 1981. This tax is expected to produce $3.5 billion in receipts in fiscal year 1981.

-- A delay in the assumed enactment date of the proposed foreign tax credit on oil and gas extraction.

In comparison to the March estimates, the revised estimates of individual and corporation incomes reduce receipts by $10.7 billion in 1980 and $18.4 billion in 1981. These reductions are partially offset by technical reestimates of income taxes and deposits of earnings by the Federal Reserve, which increase receipts by $0.6 billion in 1980 and $2.8 billion in 1981.

Table 4.--CHANGE IN BUDGET RECEIPTS, 1980 and 1981
(in billions of dollars)

	1930	1981
January budget estimate	523.8	600.0
Policy changes:		
Energy legislation as adopted by the Congress	-1.2	0.7
Withholding of taxes on interest and dividend income	---	3.4
Gasoline conservation fee/motor fuels tax	3.4	12.6
Other	-0.1	-0.3
Subtotal, Policy changes	2.1	16.4
Revised estimates of incomes	6.5	11.6
March estimate	532.4	628.0
Policy changes:		
Congressional repeal of gasoline conservation fee	-3.4	-2.4
Delay in effective date of proposed motor fuels tax	---	-6.8
Delay in assumed enactment date of proposed foreign tax credit on oil and gas extraction	-0.9	0.7
Other	-*	*
Subtotal, Policy changes	-4.3	-8.4
Revised estimates of incomes	-10.7	-18.4
Technical reestimates	0.6	2.8
Receipts, current estimate	517.9	604.0

* $50 million or less.

Budget Outlays

The current outlay estimate for 1980 is $578.8 billion, which is $9.8 billion above the March estimate and $15.2 billion above the estimate in the January budget. Outlays for 1981 are now estimated at $633.8 billion, $22.2 billion above the March estimate and $18.0 billion above the January budget.

The increases in outlays from March to the current estimates are primarily the result of three factors: the revised economic forecast; higher costs and spending rates for the defense program; and unavoidable increases because of natural disasters, the recent influx of Cuban/Haitian entrants, and other events. These changes in outlays are summarized in Table 5.

Increases in unemployment compensation of $3.3 billion in 1980 and $9.0 billion in 1981 reflect higher unemployment than anticipated in March. The recent downturn in the economy increases outlays for other income security programs by $0.5 billion in 1980 and $1.0 billion in 1981. Loans to ailing financial institutions by the Federal Savings and Loan Insurance Corporation and the Federal Deposit Insurance Corporation increase estimated outlays by an additional $1.4 billion in 1980 and $0.1 billion in 1981. A $0.5 billion increase in outlays for GNMA (Government National Mortgage Association) mortgage purchase activities in 1980 reflects slower asset sales, resulting from high interest rates and general financial conditions.

Estimated outlays for defense have increased by $1.6 billion in 1980 and $6.9 billion in 1981. These increases are in large part due to higher costs of fuel and other purchases; faster than anticipated spending under contracts previously let; higher projected Federal pay raises for military and civilian personnel; and other improvements to military pay, allowances, and benefits.

Outlay increases for disaster relief, assistance to Cuban/Haitian entrants, and other unavoidable events are estimated at $1.2 billion in 1980 and $4.1 billion in 1981. Loans to farmers to offset the impact of the Russian grain suspension increase estimated outlays in 1980 by $0.8 billion. Increases in outlays for Small Business Administration disaster loans of $0.3 billion in 1980 and $0.5 billion in 1981, reflect an increase in the demand for such loans as a consequence of the eruptions of Mount Saint Helens, civil disorders in Miami, tornadoes in Nebraska, mudslides in California, and Hurricane Frederick in Puerto Rico, Alabama, and Mississippi. Outlays for other disaster-related programs are estimated to increase by $0.3 billion in 1980 and $0.4 billion in 1981. Outlays for assistance to Cuban/Haitian entrants, including the activities of the Federal Emergency Management Agency (FEMA) are estimated to rise by $0.3 billion in 1980 and $0.2 billion in 1981. Congressional inaction on proposed hospital cost containment legislation increases estimated outlays in 1981 by $0.6 billion. Other changes reduce expected outlays by $0.4 billion in 1980 and increase outlays by $2.4 billion in 1981.

The 1980 and 1981 outlay changes since March are discussed further in Part 2.

Table 5.--CHANGE IN BUDGET OUTLAYS, 1980 AND 1981
(in billions of dollars)

	1980	1981
January budget estimate	563.6	615.8
Changes:		
Reestimates	8.0	13.0
Planned reductions	-2.6	-17.2
March estimate	568.9	611.5
Changes:		
Changed economic conditions:		
Unemployment compensation	3.3	9.0
Other income security programs	0.5	1.0
Federal Savings and Loan Insurance Corporation (FSLIC)	1.1	0.1
Federal Deposit Insurance Corporation	0.4	---
Mortgage purchase activities (GNMA)	0.5	---
Other	1.3	1.1
Subtotal	7.0	11.1
Defense-Military	1.6	6.9
Other necessary changes:		
Price support and related programs	0.8	---
SBA disaster loans	0.3	0.5
Other disaster-related	0.3	0.4
Federal Emergency Management Agency (assistance to Cuban/Haitian entrants)	0.3	0.2
Other assistance to Cuban/Haitian entrants	-*	0.1
Congressional inaction on hospital cost containment	---	0.6
Other	-0.4	2.4
Subtotal	1.2	4.1
Total changes	9.8	22.2
Current estimate	578.8	633.8

---

* $50 million or less.

Budget Authority

Budget authority in 1980 is now estimated to be $653.7 billion, $2.1 billion below the March estimate and $0.3 billion below the January budget. The current estimate of 1981 budget authority is $707.2 billion, $15.9 billion above the March estimate and $11.2 billion above the budget.

The reduction in 1980 budget authority since March is primarily the result of a congressional rescission of budget authority for the strategic petroleum reserve; enactment of the Energy Security Act, which reduces budget authority for synthetic fuels promotion; and reductions in social security and medicare trust fund receipts because of lower than expected tax collections reflecting the revised economic forecast.

Increases in unemployment compensation, the higher costs of the defense program, and a change in the accounting of the U.S. payments to the International Monetary Fund to conform to the congressional accounting method account for much of the increase in 1981 budget authority since March.

Table 6.--CHANGE IN BUDGET AUTHORITY, 1980 AND 1981
(in billions of dollars)

	1980	1981
January budget estimate	654.0	696.1
Changes:		
Reestimates	7.0	13.5
Planned reductions	-5.2	-18.3
March estimate	655.8	691.3
Changes:		
Changed economic conditions:		
Unemployment compensation	0.4	4.4
Social security	-1.2	-3.3
Other income security	-0.1	1.8
Medicare	-0.3	-0.9
Other	1.0	0.5
Subtotal	-0.2	2.5
Defense-Military	-0.1	6.9
Other necessary changes:		
International Monetary Fund	---	5.5
Synthetic fuels promotion	-1.0	*
Strategic petroleum reserve	-2.0	---
SBA disaster loans	0.8	---
Other disaster related	0.6	*
Federal Emergency Management Agency (assistance to Cuban/Haitian entrants)	0.6	---
Other assistance to Cuban/Haitian entrants	0.1	0.2
Other	-1.0	0.8
Subtotal	-1.9	6.6
Total, changes	-2.1	15.9
Current estimate	653.7	707.2

---

* $50 million or less.

The Credit Budget

In the 1981 budget, a system was proposed to restrain the growth of Federal credit activities. The system provides, where appropriate, for specific annual appropriation bill limitations on new obligations for direct loans and new commitments for loan guarantees.

Table 7.--CHANGE IN THE CREDIT BUDGET TOTALS, 1980 and 1981
(in billions of dollars)

	1980	1981
January budget totals	134.9	142.1
Changes:		
New direct loan obligations	0.3	0.6
New loan guarantee commitments	-0.8	-4.1
March totals	134.4	138.6
Changes:		
New direct loan obligations	4.5	5.0
New loan guarantee commitments	-2.0	-2.4
Current totals	136.9	141.2

In comparison to the March totals, new direct loan obligations are expected to be higher by $4.5 billion in 1980 and $5.0 billion in 1981. The major increases are in the following areas:

-- a $1.5 billion increase in 1980 and a $1.9 billion increase in 1981 for economic emergency loans in the Farmers Home Administration;

-- a $1.0 billion increase in lending by the Federal Savings and Loan Insurance Corporation in 1980 to assist thrift institutions whose financial soundness has been threatened by the current recession; and

-- an increase of $1.0 billion for Small Business Administration disaster loans in 1980 to assist businesses damaged by the Mount Saint Helens eruptions, California mudslides, and Miami civil disorders.

The July estimates for FFB direct loan obligations are higher than the March estimates by $1.0 billion in 1980 and $3.0 billion in 1981. This results primarily from higher sales of certificates of beneficial ownership by the Farmers Home Administration arising from increases in economic emergency loans in seven States of $1.0 billion in 1980 and $1.6 billion in 1981. FFB loan guarantee originations are higher due to increases in foreign military credit sales for Egyptian military procurement of $0.4 billion in both 1980 and 1981, and a $1.0 billion increase in 1981 is due to acquisition of public housing bonds by the FFB.

New loan guarantee commitments are expected to be below the March totals by $2.0 billion in 1980 and $2.4 billion in 1981. Increases of $1.0 billion in 1980 and $1.5 billion in 1981, due primarily to economic emergency loans by the Farmers Home Administration, are offset by decreases in the Veterans Administration. The decreases result from downward reestimates of the Veterans Administration loan guarantee revolving fund caused by the recession in the housing market. Other changes are due to higher demand for student loans and a decrease of $0.5 billion in low-rent public housing resulting from sales of public housing bonds to the FFB.

Table 8.--CHANGE IN THE CREDIT BUDGET TOTALS SINCE MARCH
(in billions of dollars)

	1980	1981
March totals	134.4	138.6
New direct loan obligations:		
Farmers Home Administration	1.5	1.9
Federal Savings and Loan Insurance Corporation	1.0	0.2
Small Business Administration disaster loans	1.0	---
Federal Financing Bank	1.0	3.0
HUD: Government National Mortgage Association	0.2	---
Export-Import Bank	-0.4	---
Other	0.1	-0.1
Subtotal, Direct loan changes	4.5	5.0
New loan guarantee commitments:		
Farmers Home Administraton	1.0	1.5
Veterans Administration	-2.5	-0.6
Education: Student loans	0.5	---
HUD: Low-rent public housing	---	-0.5
Interior: Office of Territorial Affairs	---	0.1
Loan guarantees held as direct loans	-1.0	-3.0
Subtotal, Loan guarantee changes	-2.0	-2.4
Current totals	136.9	141.2

Off-Budget Federal Entities

The 1980 estimate of outlays for off-budget Federal entities is $16.1 billion, which is $1.0 billion above the March estimate and $0.7 billion below the estimate in the January budget. Outlays for 1981 are above the January and March estimates by $3.6 billion and $3.0 billion, respectively.

Table 9.--CHANGE IN OUTLAYS OF
OFF-BUDGET FEDERAL ENTITIES, 1980 and 1981
(in billions of dollars)

	1980	1981
January estimate	16.8	18.1
Changes:		
Federal Financing Bank	-1.7	0.6
March estimate	15.0	18.7
Changes:		
Federal Financing Bank	1.3	3.0
Other	-0.3	---
Current estimate	16.1	21.7

Since March, estimated outlays of the Federal Financing Bank (FFB) have increased by $1.3 billion in 1980 and $3.0 billion in 1981. Higher sales of certificates of beneficial ownership by the Farmers Home Administration, arising from increases in economic emergency loans in seven States, and increases in foreign military credit sales for Egyptian military procurement are primarily responsible for the increases in each year.

Comparison of Administration and Budget Resolution Totals

As the following table shows, the current Administration estimates differ from the totals in both the third budget resolution for 1980 and the first budget resolution for 1981. Virtually all of the differences in the 1980 totals and a large part of the differences for 1981 reflect differing assumptions about the economy, spending trends in existing programs, and other technical differences. The basic assumptions in the resolution were developed in the early spring, when the economic outlook was somewhat different from the current projections. As a result, the Administration is now estimating lower receipts and higher outlays for several programs, notably unemployment benefits, than was assumed in the 1980 and 1981 resolutions.

Table 10.--ADMINISTRATION AND BUDGET RESOLUTION TOTALS
(in billions of dollars)

	1980		1981	
	Third Resolution	Mid-Session Review	First Resolution	Mid-Session Review
Receipts.........	525.7	517.9	613.8	604.0
Outlays..........	572.65	578.8	613.6	633.8
Deficit (-) or surplus (+)..	-46.95	-60.9	0.2	-29.8
Budget authority.	658.85	653.7	697.2	707.2

For 1980, the current Administration estimate of receipts is $7.8 billion below the resolution, and the Administration estimate of outlays is $6.1 billion higher. Higher outlays for unemployment benefits ($2.2 billion) and mortgage credit insurance ($1.8 billion) account for much of the difference. The current Administration budget authority total is $5.1 billion below the resolution, largely because the Administration projects lower receipts for social insurance trust funds and because of an accounting difference relating to loan guarantees for the Chrysler Corporation.

For 1981, the current Administration estimate of receipts is $9 billion below the first resolution. The Administration's current estimate of receipts under existing law is $17 billion below the resolution due to revised economic assumptions and other estimating differences. However, the legislative proposals in the Mid-Session Review increase receipts by $11.5 billion, which is $7.3 billion above the resolution total for proposed legislation.

The Administration's estimate of 1981 outlays is $20 billion above the resolution, and budget authority is $10 billion higher.

There are a large number of estimating differences between the resolution and Administration estimates. For example, the Mid-Session Review estimate of outlays for unemployment benefits is $8-1/2 billion above the resolution, and the Mid-Session Review estimate of net interest is $3.8 billion below the resolution. The resolution includes many of the legislative savings proposed by the Administration. It also assumes some policy reductions below the budget. For example, the resolution does not include $500 million in budget authority and outlays that the Administration has requested for local government transitional aid, and assumes reductions in a variety of other programs.

The major differences between the current Administration estimates and the first budget resolution for 1981 are in the following functions:

-- National defense.--The resolution is below the current Administration estimate total for this function by $1.0 billion in budget authority and by $3.8 billion in outlays. The Administration estimates have been revised upward to reflect increased costs for fuel and military pay and allowances, and because of increased operations in the Persian Gulf/Indian Ocean area. Much of the difference in outlays reflects differing assumptions about spend-out rates.

-- International affairs.--The resolution is above the current Administration estimate of budget authority by $0.1 billion and below the current estimate of outlays by $0.8 billion. Adjusting for estimating differences, the resolution appears to imply policy cuts of over $1 billion in budget authority and at least $0.2 billion in outlays.

-- Energy.--The resolution is $0.5 billion in budget authority and $0.4 billion in outlays below the Administration estimates for this function. Most of the reduction would appear to be for the strategic petroleum reserve.

-- Natural resources and environment.--The resolution is below the Administration's current estimates by $0.9 billion in budget authority and $1.0 billion in outlays. The resolution assumes lower amounts for pollution control and other programs.

-- Commerce and housing credit.--The resolution is below the current Administration estimates by $0.5 billion in budget authority and $0.7 billion in outlays. The resolution assumes Postal Service savings of $500 million, compared to $250 million in the Mid-Session Review. Adjusting for reestimates, the resolution also appears to imply policy reductions in other programs of about $0.4 billion in budget authority and outlays.

-- Transportation.--The resolution is below the Administration's current estimate by $1.3 billion in budget authority and $0.5 billion in outlays. While the resolution assumes cuts in many areas, the biggest differences appear to be in highways and mass transit programs.

-- Education, training, employment and social services.--The resolution is below the current estimates by $1.3 billion in budget authority and $1.4 billion in outlays, and appears to assume smaller amounts than the Administration for the President's youth initiative and for public service jobs.

-- Health.--The resolution is above the current estimate of health budget authority by $0.7 billion, mainly due to differing assumptions about the level of medicare trust fund receipts. For outlays, the resolution is $1.7 billion below the Administration estimate. Most of the difference is in the estimates for medicare and medicaid, where the current Administration estimates reflect upward revisions in benefits under existing law and downward revisions in savings under proposed legislation.

-- Income security.--The resolution budget authority and outlay totals for this function are $5.2 billion and $10.8 billion, respectively, below the current Administration totals. The current Administration estimates reflect substantial upward revisions in programs sensitive to unemployment rates. The Mid-Session Review outlay estimate of unemployment compensation is $8-1/2 billion above the resolution, and the estimate of food stamps is $1-1/2 billion higher. There are also a variety of other, largely offsetting, differences in the estimates of other benefit payments. The resolution does assume a policy cut of $2.0 billion in budget authority for housing assistance, and a $0.4 billion cut in budget authority and outlays for low-income energy assistance.

-- Veterans benefits and services.--The resolution totals for this function are $1.1 billion and $0.6 billion below the Administration budget authority and outlay estimates. About half of these differences appear to reflect reestimates, and the remainder are policy reductions.

-- General purpose fiscal assistance.--The resolution totals for this function do not include local government transitional aid, and are therefore $0.5-billion below the Administration estimates of budget authority and outlays.

-- Net interest.--The resolution estimates of net interest cost are $3.8 billion above Administration projections because of differing economic assumptions and technical differences in making the projections.

-- Other.--The resolution also assumes reductions in the general government and community and regional development functions. The resolution totals for science and space, agriculture, and justice are within $0.1 billion of the Administration totals. The resolution includes no allowances function. The Mid-Session Review estimates include $2.0 billion in budget authority and $1.5 billion in outlays for contingencies and pay.

Table 11.--BUDGET RECEIPTS BY MAJOR SOURCE, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
Individual income taxes.........	217.8	238.7	241.5	240.7	274.4	283.3	278.2
Corporation income taxes........	65.7	72.3	74.2	65.5	71.6	74.1	66.4
Social insurance taxes and contributions..................	141.6	162.2	163.5	160.5	187.4	188.9	184.5
Excise taxes....................	18.7	26.3	25.2	25.4	40.2	52.4	48.7
Estate and gift taxes...........	5.4	5.8	5.8	6.1	5.9	6.0	6.3
Customs duties..................	7.4	7.6	7.3	7.0	8.4	7.8	7.5
Miscellaneous receipts..........	9.2	10.9	14.9	12.7	12.1	15.5	12.5
Total budget receipts......	465.9	523.8	532.4	517.9	600.0	628.0	604.0

Table 12.--BUDGET OUTLAYS BY FUNCTION, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
National defense 1/	117.7	130.4	134.0	135.6	146.2	150.5	157.5
International affairs	6.1	10.4	11.1	10.9	9.6	10.1	10.3
General science, space, and technology	5.0	5.9	5.9	5.7	6.4	6.2	6.2
Energy	6.9	7.8	6.8	6.5	8.1	6.9	7.2
Natural resources and environment	12.1	12.8	12.8	13.7	12.8	12.5	13.1
Agriculture	6.2	4.6	5.1	5.8	2.8	2.0	2.2
Commerce and housing credit	2.6	5.5	6.2	8.3	0.7	0.4	0.7
Transportation	17.5	19.6	20.5	20.8	20.2	19.0	19.2
Community and regional development	9.5	8.5	9.0	9.5	8.8	8.5	9.3
Education, training, employment, and social services	29.7	30.7	30.1	29.9	32.0	30.6	30.9
Health	49.6	56.6	56.5	56.9	62.4	61.9	63.4
Income security	160.2	190.9	190.0	193.5	220.0	220.1	230.4
(Social security)	(102.6)	(117.9)	(117.9)	(117.8)	(136.9)	(138.3)	(137.8)
(Other)	(57.6)	(73.0)	(72.1)	(75.7)	(83.1)	(81.8)	(92.6)
Veterans benefits and services	19.9	20.8	20.7	20.9	21.7	21.4	21.8
Administration of justice	4.2	4.5	4.6	4.6	4.7	4.6	4.6
General government	4.2	4.9	4.8	5.0	4.9	4.8	4.7
General purpose fiscal assistance	8.4	8.7	8.8	8.6	9.6	7.4	7.3
Interest	52.6	63.3	64.3	64.3	67.2	68.4	67.6
Allowances 2/	---	0.1	---	-*	2.6	1.4	1.4
Undistributed offsetting receipts	-18.5	-22.3	-22.2	-21.9	-25.1	-24.9	-24.0
(Employer share, employee retirement)	(-5.3)	(-5.9)	(-5.9)	(-5.9)	(-6.2)	(-6.2)	(-6.3)
(Interest received by trust funds)	(-9.9)	(-11.5)	(-11.7)	(-11.4)	(-13.0)	(-13.2)	(-12.5)
(Rents and royalties on the Outer Continental Shelf)	(-3.3)	(-4.8)	(-4.6)	(-4.6)	(-6.0)	(-5.5)	(-5.2)
Total budget outlays	493.7	563.6	568.9	578.8	615.8	611.5	633.8

1/ The 1981 estimates include allowances for civilian and military pay raises for the Department of Defense.

2/ The 1981 estimates include allowances for civilian agency pay raises. The current 1980 and 1981 estimates include an allowance for the government-wide rescission of furniture purchases as provided in the 1980 Supplemental Appropriations and Rescission Act. The current 1981 estimate also includes an allowance for the care, maintenance, and resettlement of recent Cuban/Haitian entrants.

* $50 million or less.

Table 13.--BUDGET OUTLAYS BY AGENCY, 1979-1981
(In billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
Legislative branch	1.1	1.3	1.3	1.3	1.3	1.3	1.3
The Judiciary	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Executive Office of the President	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Funds appropriated to the President	2.6	9.5	9.1	7.6	9.3	8.0	6.0
Agriculture	20.6	23.6	24.0	25.7	20.1	18.7	20.6
Commerce	4.1	3.6	3.5	3.8	3.4	3.1	2.9
Defense--Military 1/	115.0	127.4	131.0	132.6	142.7	147.0	153.9
Defense--Civil	2.9	3.2	3.2	3.5	3.1	2.9	3.1
Education	10.9	12.9	12.9	12.5	13.5	13.1	13.3
Energy	7.9	7.7	6.9	6.5	8.7	7.9	8.4
Health and Human Services	170.3	193.7	193.4	194.1	219.3	220.3	224.1
Housing and Urban Development	9.2	11.6	12.0	12.6	11.8	11.8	11.9
Interior	4.1	4.2	4.1	4.0	4.2	3.9	4.0
Justice	2.5	2.6	2.6	2.7	2.7	2.6	2.6
Labor	22.6	27.5	26.2	29.6	31.8	30.4	39.4
State	1.5	2.0	2.0	1.9	2.2	2.2	2.2
Transportation	15.6	17.3	18.3	18.6	17.9	17.2	17.7
Treasury	65.0	75.8	76.9	76.5	80.3	79.2	78.3
Environmental Protection Agency	4.8	5.0	5.3	5.7	5.2	5.4	5.5
National Aeronautics and Space Administration	4.2	5.0	5.0	4.9	5.4	5.2	5.2
Veterans Administration	19.9	20.7	20.6	20.8	21.7	21.4	21.7
Office of Personnel Management	12.7	14.9	14.9	14.9	17.4	17.1	17.0
Other independent agencies	14.1	15.4	17.0	20.3	15.6	15.8	16.5
Allowances 2/	---	0.1	---	-*	2.6	1.4	1.4
Undistributed offsetting receipts	-18.5	-22.3	-22.2	-21.9	-25.1	-24.9	-24.0
Total budget outlays	493.7	563.6	568.9	578.8	615.8	611.5	633.8

1/ The 1981 estimates include allowances for civilian and military pay raises for the Department of Defense.

2/ The 1981 estimates include allowances for civilian agency pay raises. The current 1980 and 1981 estimates include an allowance for the government-wide rescission of furniture purchases as provided in the 1980 Supplemental Appropriations and Rescission Act. The current 1981 estimate also includes an allowance for the care, maintenance, and resettlement of recent Cuban/Haitian entrants.

* $50 million or less.

Table 14.--BUDGET AUTHORITY BY FUNCTION, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
National defense 1/	127.9	141.6	144.0	143.9	161.8	164.5	171.5
International affairs	8.7	13.1	13.4	13.4	16.9	18.2	23.5
General science, space, and technology	5.4	6.2	6.2	6.1	6.9	6.6	6.6
Energy	7.4	41.5	40.7	37.5	7.4	6.9	7.2
Natural resources and environment	13.2	12.7	12.2	13.3	13.3	12.5	12.6
Agriculture	9.3	5.0	5.0	5.1	5.5	5.4	5.4
Commerce and housing credit	5.9	10.2	10.2	10.4	5.9	5.6	5.6
Transportation	19.2	21.0	20.4	20.3	23.6	23.4	23.4
Community and regional development	10.0	8.9	8.6	9.8	9.8	9.0	9.1
Education, training, employment, and social services	32.6	31.2	30.7	30.7	34.8	33.0	33.0
Health	53.9	60.0	59.9	59.6	71.5	71.1	70.5
Income security	191.9	222.1	223.3	222.2	251.5	251.6	254.7
(Social security)	(100.6)	(115.5)	(116.7)	(115.5)	(131.1)	(132.5)	(129.2)
(Other)	(91.3)	(106.7)	(106.6)	(106.7)	(120.3)	(119.1)	(125.5)
Veterans benefits and services	20.5	21.2	21.2	21.2	22.7	22.5	22.8
Administration of justice	4.2	4.4	4.4	4.4	4.7	4.3	4.3
General government	4.4	4.9	4.9	5.1	4.9	4.9	4.8
General purpose fiscal assistance	8.3	8.7	8.8	8.6	9.6	6.8	6.7
Interest	52.6	63.3	64.3	64.3	67.2	68.4	67.6
Allowances 2/	---	0.2	---	-0.2	3.1	1.7	2.0
Undistributed offsetting receipts	-18.5	-22.3	-22.2	-21.9	-25.1	-24.9	-24.0
(Employer share, employee retirement)	(-5.3)	(-5.9)	(-5.9)	(-5.9)	(-6.2)	(-6.2)	(-6.3)
(Interest received by trust funds)	(-9.9)	(-11.5)	(-11.7)	(-11.4)	(-13.0)	(-13.2)	(-12.5)
(Rents and royalties on the (Outer Continental Shelf)	(-3.3)	(-4.8)	(-4.6)	(-4.6)	(-6.0)	(-5.5)	(-5.2)
Total budget authority	556.7	654.0	655.8	653.7	696.1	691.3	707.2

1/ The 1981 estimates include allowances for civilian and military pay raises for the Department of Defense.

2/ The 1981 estimates include allowances for civilian agency pay raises. The current 1980 estimate includes an allowance for the government-wide rescission of furniture purchases, as provided in the 1980 Supplemental Appropriations and Rescission Act. The current 1981 estimate includes an allowance for the care, maintenance, and resettlement of recent Cuban/Haitian entrants.

Table 15.--BUDGET AUTHORITY BY AGENCY, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
Legislative branch	1.1	1.3	1.3	1.3	1.3	1.3	1.3
The Judiciary	0.5	0.6	0.6	0.6	0.7	0.7	0.7
Executive Office of the President	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Funds appropriated to the President	5.9	13.0	12.4	11.0	11.4	12.0	14.0
Agriculture	24.5	24.7	24.6	25.3	24.6	23.9	25.4
Commerce	2.6	3.7	3.2	3.1	3.4	2.9	2.9
Defense--Military 1/	125.0	138.6	140.9	140.8	158.2	160.9	167.8
Defense--Civil	2.8	2.9	2.9	3.3	3.0	2.9	2.9
Education	12.6	13.9	13.6	13.4	15.5	15.1	15.1
Energy	10.3	10.5	9.9	11.0	10.2	10.1	10.6
Health and Human Services	172.8	195.4	196.4	195.3	222.9	224.0	222.9
Housing and Urban Development	31.1	35.7	35.5	35.6	40.4	40.3	40.3
Interior	4.7	4.6	4.3	4.6	4.7	4.1	4.1
Justice	2.5	2.5	2.4	2.5	2.7	2.2	2.2
Labor	28.6	28.1	27.8	28.3	33.0	31.3	35.7
State	1.7	2.1	2.1	2.1	2.3	2.3	2.4
Transportation	17.2	17.8	17.8	18.4	20.5	20.3	21.9
Treasury	64.7	94.1	95.1	90.3	80.9	79.2	78.2
Environmental Protection Agency	5.4	4.7	4.7	4.7	5.3	5.3	5.3
National Aeronautics and Space Administration	4.5	5.3	5.3	5.2	5.7	5.5	5.5
Veterans Administration	20.5	21.2	21.2	21.2	22.7	22.4	22.8
Office of Personnel Management	21.0	24.5	24.5	24.5	26.7	26.3	26.6
Other independent agencies	14.9	30.8	31.3	33.3	21.9	21.2	20.6
Allowances 2/	---	0.2	---	-0.2	3.1	1.7	2.0
Undistributed offsetting receipts	-18.5	-22.3	-22.2	-21.9	-25.1	-24.9	-24.0
Total budget authority	556.7	654.0	655.8	653.7	696.1	691.3	707.2

1/ The 1981 estimates include allowances for civilian and military pay raises for the Department of Defense.

2/ The 1981 estimates include allowances for civilian agency pay raises. The current 1980 estimate includes an allowance for the government-wide rescission of furniture purchases, as provided in the 1980 Supplemental Appropriations and Rescission Act. The current 1981 estimate includes an allowance for the care, maintenance and resettlement of recent Cuban/Haitian entrants.

Table 16.--BUDGET SURPLUS OR DEFICIT (-) BY FUND GROUP AND TYPE OF TRANSACTION, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
Federal Funds							
Transactions with the public............	-14.8	-24.0	-14.7	-33.0	-6.5	42.1	9.0
Transactions with trust funds...........	-31.2	-33.9	-35.4	-36.1	-40.0	-39.8	-43.4
Total..............................	-46.1	-57.8	-50.1	-69.0	-46.5	2.4	-34.4
Trust Funds							
Transactions with the public............	-12.9	-15.8	-21.8	-27.9	-9.3	-25.6	-38.8
Transactions with Federal funds.........	31.2	33.9	35.4	36.1	40.0	39.8	43.4
Total..............................	18.3	18.1	13.6	8.2	30.8	14.1	4.6
Budget Totals							
Federal funds..........................	-46.1	-57.8	-50.1	-69.0	-46.5	2.4	-34.4
Trust funds............................	18.3	18.1	13.6	8.2	30.8	14.1	4.6
Total..............................	-27.7	-39.8	-36.5	-60.9	-15.8	16.5	-29.8

Table 17.--BUDGET RECEIPTS AND OUTLAYS BY FUND GROUP, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
Receipts							
Federal funds	316.4	347.8	361.3	348.7	383.2	430.5	410.2
Trust funds	189.6	222.2	216.0	212.8	265.1	243.6	242.3
Interfund transactions	-40.1	-46.2	-44.9	-43.7	-48.3	-46.1	-48.5
Total	465.9	523.8	532.4	517.9	600.0	628.0	604.0
Outlays							
Federal funds	362.4	405.7	411.4	417.8	429.7	428.1	444.6
Trust funds	171.3	204.1	202.4	204.7	234.3	229.5	237.6
Interfund transactions	-40.1	-46.2	-44.9	-43.7	-48.3	-46.1	-48.5
Total	493.7	563.6	568.9	578.8	615.8	611.5	633.8
Surplus or Deficit (-)							
Federal funds	-46.1	-57.8	-50.1	-69.0	-46.5	2.4	-34.4
Trust funds	18.3	18.1	13.6	8.2	30.8	14.1	4.6
Total	-27.7	-39.8	-36.5	-60.9	-15.8	16.5	-29.8

Table 18.--DEBT SUBJECT TO LIMIT, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
Unified budget deficit or surplus (-).....	27.7	39.8	36.5	60.9	15.8	-16.5	29.8
Portion of budget deficit attributable to trust funds surplus or deficit (-) 1/.	18.3	18.1	13.6	8.2	30.8	14.1	4.6
Federal funds deficit or surplus (-)....................	46.1	57.8	50.1	69.0	46.5	-2.4	34.4
Deficit of off-budget Federal entities....	12.4	16.8	15.0	16.1	18.1	18.7	21.7
Total to be financed..............	58.5	74.6	65.1	85.1	64.6	16.3	56.1
Means of financing other than borrowing, and other adjustments 1/.................	-3.6	-15.0	-11.8	-11.8	-17.6	-0.2	-0.2
Change in debt subject to limit...	54.9	59.6	53.4	73.3	47.1	16.1	56.0
Debt subject to limit, beginning of year 2/..................................	772.7	827.6	827.6	827.6	887.2	881.0	900.9
Anticipated debt subject to limit, end of year 2/..........................	827.6	887.2	881.0	900.9	934.2	897.1	956.9

1/ The changes from the January to March estimates are largely due to the reclassification of the energy security program from a trust fund to Federal funds, in accordance with the legislation adopted by the Congress on the energy program. This directly reduces the trust fund surplus and raises the Federal fund surplus by an equal amount. Since the budget assumed that the trust fund balances for this program would not be invested in Federal securities, a change in the adjustment for the means of financing other than borrowing also reflects this reclassification. Thus, the reclassification had no effect on the change in debt subject to limit.

2/ The statutory debt limit is permanently established at $400 billion. Public Law 96-286 temporarily increased the statutory debt limit to $925 billion through February 28, 1981.

Table 19.--THE CREDIT BUDGET TOTALS, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
New direct loan obligations:							
On-budget	33.9	36.4	37.2	40.6	35.4	35.4	37.4
Off-budget	17.5	23.3	22.8	23.9	25.3	25.8	28.8
Total, New direct loan obligations	51.4	59.7	60.0	64.5	60.7	61.2	66.2
New loan guarantee commitments 1/	74.7	75.2	74.4	72.4	81.4	77.4	75.0
Total	126.1	134.9	134.4	136.9	142.1	138.6	141.2

1/ To avoid double counting, excludes commitments for guarantee of loans previously guaranteed and for guarantee by one Government account of direct loans made by another Government account.

Table 20.--NEW DIRECT LOAN OBLIGATIONS BY AGENCY, 1979-1981
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	January	March	Current	January	March	Current
On-budget agencies:							
Funds appropriated to the President....	1.3	1.7	1.7	1.7	2.0	2.0	2.0
Agriculture..............................	21.3	20.8	21.2	22.7	18.2	18.4	20.3
Commerce.................................	0.1	0.3	0.1	0.1	0.5	0.4	0.4
Defense..................................	*	---	---	---	---	---	---
Education................................	0.7	0.7	0.6	0.7	1.3	1.3	1.3
Energy...................................	---	*	*	*	*	*	*
Health and Human Services..............	0.1	0.1	0.1	0.1	0.2	0.2	0.2
Housing and Urban Development..........	3.6	3.8	3.7	3.9	3.4	3.4	3.4
Interior.................................	*	*	*	*	0.1	0.1	0.1
Justice..................................	*	---	---	---	---	---	---
State....................................	*	*	*	*	*	*	*
Transportation...........................	0.1	0.2	0.2	0.2	0.3	0.3	0.3
Treasury.................................	*	---	---	---	---	---	---
Veterans Administration................	0.6	0.7	0.7	0.6	0.8	0.7	0.6
Other independent agencies:							
Export-Import Bank....................	4.1	4.5	4.5	4.1	4.8	4.8	4.8
Federal Savings and Loan Insurance Corporation..........................	*	0.1	0.7	1.7	*	*	0.2
National Credit Union Administration	*	1.8	1.8	1.8	2.2	2.2	2.2
Small Business Administration.......	1.8	1.4	1.6	2.6	1.4	1.4	1.4
All other independent agencies......	0.2	0.3	0.3	0.4	0.4	0.3	0.3
Subtotal, On-budget agencies......	33.9	35.4	37.2	40.6	35.4	35.4	37.4
Off-budget entities:							
Rural Electrification Administration...	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Federal Financing Bank.................	16.0	22.0	21.5	22.5	23.9	24.5	27.5
All other off-budget entities..........	0.1	*	*	*	*	*	*
Subtotal, Off-budget entities.....	17.5	23.3	22.8	23.9	25.3	25.8	28.8
Total..............................	51.4	59.7	60.0	64.5	60.7	61.2	66.2

* $50 million or less

Table 21.--NEW LOAN GUARANTEE COMMITMENTS BY AGENCY, 1979-1981
(in billions of dollars)

	1979 Actual	1980 Estimate January	1980 Estimate March	1980 Estimate Current	1981 Estimate January	1981 Estimate March	1981 Estimate Current
Funds appropriated to the President	5.4	2.2	2.1	1.9	2.7	2.8	2.7
Agriculture 1/	17.8	19.1	19.1	20.1	21.4	21.0	22.5
Commerce	1.7	2.0	1.5	1.5	3.2	2.1	2.1
Defense	---	*	*	*	*	*	*
Education	3.3	4.6	4.9	5.4	2.2	2.2	2.2
Energy	*	1.9	1.9	2.1	0.2	0.2	0.4
Health and Human Services	*	0.2	0.2	0.2	0.3	0.2	0.2
Housing and Urban Development	88.8	90.3	90.3	90.3	102.1	102.1	101.5
Interior	*	---	---	---	*	*	0.1
Transportation	0.2	1.0	1.0	1.0	0.8	0.8	0.8
Treasury	0.5	1.8	1.8	1.8	0.3	0.3	0.3
National Aeronautics and Space Administration	0.2	---	---	---	---	---	---
Veterans Administration	8.1	10.3	10.3	7.8	10.4	10.4	9.8
Other independent agencies:							
Energy Security Corporation 2/	---	0.8	0.8	0.8	2.0	2.0	2.0
Export-Import Bank	5.0	7.8	6.8	6.8	8.9	7.6	7.6
Small Business Administration	4.2	5.3	5.4	5.4	5.8	5.3	5.3
All other independent agencies	*	*	*	*	*	*	*
Less: Secondary guarantees of loans that are already guaranteed	-42.4	-48.0	-48.0	-48.0	-53.1	-53.1	-53.1
Less: Guaranteed loans held as direct loans	-18.1	-24.1	-23.6	-24.6	-25.8	-26.3	-29.3
Total	74.7	75.2	74.4	72.4	81.4	77.4	75.0

1/ Includes Rural Electrification Administration off-budget activities as follows: 1979, $6.0 billion; 1980, $5.9 billion in the January estimate and $5.9 billion in the March and current estimates; and 1981, $6.0 billion in the January estimate and $6.0 billion in the March and current estimates.

2/ This is an off-budget Federal entity.

* $50 million or less.

Part 2

CHANGES IN BUDGET AUTHORITY AND OUTLAYS BY FUNCTION, 1980-1981

050: NATIONAL DEFENSE

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate............................	127.8	144.0	164.5
Changes:			
DOD-Military.........................	---	-0.1	6.9
Other................................	---	-*	0.1
Current estimate..........................	127.8	143.9	171.5
Outlays			
March estimate............................	117.7	134.0	150.5
Changes:			
DOD-Military.........................	---	1.6	6.9
Other................................	---	-*	0.1
Current estimate..........................	117.7	135.6	157.5

---

* $50 million or less.

Estimated 1980 outlays for the national defense function have increased by $1.6 billion since the March revisions, to $135.6 billion. Outlays estimated for 1981 have increased by $7.0 billion, to $157.5 billion. Budget authority for 1980 has decreased by $0.1 billion, while that for 1981 has increased by $7.0 billion.

Most of the changes have occurred in the Department of Defense military functions. These changes reflect the results of congressional actions since March together with increased operations in the Persian Gulf/Indian Ocean area; higher costs of fuel and other purchases; higher projected Federal pay raises for military and civilian personnel; and other improvements to military pay, allowances and benefits. The projected October 1981 pay raise under comprehensive legislation proposed by the Administration is now 9.1% for military personnel and 7.8% for civilian personnel (see discussion under function 920, allowances). In addition, outlay estimates have been revised upward to reflect higher than anticipated spending in recent months under contracts previously made.

The Administration's commitment to real growth in defense is maintained in the Review by a budget amendment proposed for 1981 that will cover the increased costs of fuel and other purchases in 1980 and 1981.

150: INTERNATIONAL AFFAIRS

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	8.7	13.4	18.2
Changes:			
Payments to the International Monetary Fund	---	---	5.5
Military sales trust fund	---	0.8	---
Export-Import Bank	---	-0.2	-0.6
Multilateral development banks	---	-0.3	0.1
P.L. 480 - Food aid	---	-0.1	---
Other foreign aid	---	-0.2	0.1
Other	---	-*	0.1
Current estimate	8.7	13.4	23.5
Outlays			
March estimate	6.1	11.1	10.1
Changes:			
Military sales trust fund	---	-0.2	---
Export-Import Bank	---	0.1	-*
Exchange stabilization fund	---	*	0.2
P.L. 480 - Food aid	---	-0.1	---
Other	---	*	0.1
Current estimate	6.1	10.9	10.3

* $50 million or less.

The current estimate for 1980 budget authority for this function is only slightly above the March estimate in total. This change reflects an upward reestimate of $0.8 billion in budget authority for the military sales trust fund, which is largely offset by decreases in the Export-Import Bank, multilateral development banks, P.L. 480 food aid, and other foreign aid programs resulting from congressional action on the 1980 Foreign Assistance Bill. The current 1981 budget authority estimate is $5.2 billion higher than the March estimate. Because of a change in the accounting of the U.S. payments to the International Monetary Fund to conform to the congressional accounting method, estimated budget authority in 1981 increases by $5.5 billion. This change does not affect outlays. A $0.6 billion decrease in 1981 budget authority for the Export-Import Bank reflects congressional action on the 1980 supplemental ($-0.3 billion) and the correction of a technical error in the March estimates of redemption of debt ($-0.3 billion).

For outlays, offsetting changes leave the current 1980 esti $0.2 billion below the March estimate. Decreases of $0.2 bil. for reestimates in the military sales trust fund and $0.1 bill. in P.L. 480 food aid resulting from congressional action on the 1980 Foreign Aid Bill are largely offset by increases for the Export-Import Bank and other programs. The 1981 estimate of outlays for this function is $0.2 billion above the March estimate because of revised assumptions about interest rates on U.S. securities held by the exchange stabilization fund and due to changes in the fund's balance of U.S. securities arising from changes in the composition of exchange stabilization fund currency balances.

250: GENERAL SCIENCE, SPACE, AND TECHNOLOGY

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	5.4	6.2	6.6
Changes:			
Space	---	---	---
Science	---	-*	---
Current estimate	5.4	6.1	6.6
Outlays			
March estimate	5.0	5.9	6.2
Changes:			
Space	---	-0.1	---
Science	---	-*	---
Current estimate	5.0	5.7	6.2

---

* $50 million or less.

In response to the need to reduce Federal outlays, NASA has taken administrative actions to improve their cash flow. By more careful management of accounts receivable, 1980 outlays for space construction and research and development programs have been reduced by $0.1 billion.

270: ENERGY

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	7.4	40.7	6.9
Changes:			
Synthetic fuels promotion	---	-1.0	---
Petroleum reserve receipts	---	0.2	0.1
Other energy supply	---	-0.2	0.1
Strategic petroleum reserve	---	-2.0	---
Other energy	---	-0.1	0.1
Current estimate	7.4	37.5	7.2
Outlays			
March estimate	6.9	6.8	6.9
Changes:			
Synthetic fuels promotion	---	-0.1	0.1
Petroleum reserve receipts	---	0.2	0.1
Other energy supply	---	-0.4	0.2
Strategic petroleum reserve	---	-0.1	0.1
Other	---	*	-*
Current estimate	6.9	6.5	7.2

---

* $50 million or less.

The current estimates of budget authority and outlays for the energy function are below the March estimates in 1980 and above the March estimates in 1981. Receipts from Federal petroleum reserve sales are reduced by $0.2 billion in 1980 and by $0.1 billion in 1981 because of changed production and price assumptions. Since these sales are counted as an offsetting receipt, these reductions have the effect of increasing budget authority and outlays for the function.

The enactment of the Energy Security Act reduces budget authority by $1.0 billion and outlays by $0.1 billion in 1980, while 1981 outlays are increased by $0.1 billion.

Delays in construction of uranium enrichment facilities and increases in fossil energy research and development programs are primarily responsible for the $0.2 billion decrease in budget authority in 1980 and the $0.1 billion rise in budget authority for other energy supply in 1981. Budget authority is reduced by $0.1 billion in 1980 and increased by the same amount in 1981 because of congressional inaction on the Administration's proposed supplemental for a national gasoline rationing plan.

Budget authority for the strategic petroleum reserve is reduced by $2.0 billion in 1980 as a result of a congressional rescission of that amount. Estimated outlays for the strategic petroleum reserve are decreased by $0.1 billion in 1980 because of delays in construction and increased by $0.1 billion in 1981 because of increased construction and revised price assumptions. These estimates assume the same rate of oil acquisitions that was assumed in the March update, and may be revised further on the basis of experience with the provisions of the recently-passed Energy Security Act that apply to the strategic petroleum reserve.

300: NATURAL RESOURCES AND ENVIRONMENT

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate............................	13.2	12.2	12.5
Changes:			
Offsetting receipts..................	---	0.4	0.1
Corps of Engineers...................	---	0.4	---
Land and water conservation fund.....	---	0.3	*
Other................................	---	0.1	*
Current estimate..........................	13.2	13.3	12.6
Outlays			
March estimate............................	12.1	12.8	12.5
Changes:			
Corps of Engineers...................	---	0.2	0.2
EPA sewage plant construction grants.	---	0.2	*
Land and water conservation fund.....	---	0.1	0.1
Regulatory and research programs.....	---	0.1	0.1
Water and Power Resources Service....	---	-0.1	*
Offsetting receipts..................	---	0.4	0.1
Other................................	---	-0.1	0.1
Current estimate..........................	12.1	13.7	13.1

---

* $50 million or less.

The current outlay and budget authority estimates for this function are above the March estimates, in large part due to reestimates based on actual experience to date.

A $0.4 billion increase in estimated budget authority for the Corps of Engineers in 1980 reflects the cost of repairing flood control and navigation works following the Mount Saint Helens eruptions. Outlays for the Corps of Engineers are estimated to increase by $0.2 billion in 1980 and in 1981.

A smaller than previously anticipated timber harvest reduces estimated Forest Service offsetting receipts in 1980 and 1981. These reductions in offsetting receipts increase estimated outlays and budget authority by $0.4 billion in 1980 and $0.1 billion in 1981.

Changes in budget authority and outlay estimates for sewage treatment construction grants, the land and water conservation fund, regulatory and research programs, and the Water and Power Resources Service reflect reestimates based on actual experience to date.

350: AGRICULTURE

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate............................	9.3	5.0	5.4
Changes:			
Agricultural credit insurance fund...	---	0.1	---
Other................................	---	*	*
Current estimate..........................	9.3	5.1	5.4
Outlays			
March estimate............................	6.2	5.1	2.0
Changes:			
Price support and related programs...	---	0.8	*
Agricultural credit insurance fund...	---	*	0.1
Research programs....................	---	*	0.1
Other................................	---	*	*
Current estimate..........................	6.2	5.8	2.2

* $50 million or less.

The current estimates of budget authority for the agriculture function are very close to the March estimates. Estimated outlays are $0.8 billion higher in 1980, and $0.2 billion higher in 1981.

The largest change in outlays is a $0.8 billion increase in 1980 for price support programs. This is due primarily to expenditures resulting from increases in corn and wheat loans, which were made to offset the impact on farmers of the Russian grain suspension. Because of current weather and market conditions, estimates for price support outlays are very uncertain. In addition to the normal variation expected from world weather patterns and commodity market conditions, major uncertainties are caused by the current adverse weather conditions in the Western and Southern United States and Canada. Spring-planted crops are subject to significant variation in damage depending on the timing, severity, and persistence of current bad growing conditions.

370: COMMERCE AND HOUSING CREDIT

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate............................	5.9	10.2	5.6
Changes:			
Mortgage purchase activities (GNMA)..	---	0.2	---
Rural housing programs...............	---	*	---
Other...............................	---	*	*
Current estimate..........................	5.9	10.4	5.6
Outlays			
March estimate............................	2.6	6.2	0.4
Changes:			
Mortgage purchase activities (GNMA)..	---	0.5	---
Rural housing programs...............	---	*	0.2
Federal Deposit Insurance Corporation........................	---	0.4	---
Federal Home Loan Bank Board.........	---	1.1	0.1
Other...............................	---	0.2	0.1
Current estimate..........................	2.6	8.3	0.7

* $50 million or less.

Estimated budget authority for the commerce and housing credit function is virtually unchanged since March for both 1980 and 1981. Estimated outlays have increased substantially in 1980 and only slightly in 1981.

A $0.5 billion increase in outlays and a $0.2 billion increase in budget authority for GNMA (Government National Mortgage Association) mortgage purchase activities in 1980 is due to slower asset sales than anticipated since March. This results from high interest rates and general financial conditions. A direct loan by the Federal Deposit Insurance Corporation to the First Pennsylvania Bank to cover losses from investments adds $0.4 billion to estimated outlays in 1980. The $1.1 billion increase in estimated outlays for the Federal Home Loan Bank Board in 1980 results from increased aid to support savings and loans for losses caused by prolonged high interest rates, low-yielding portfolios, and problems arising from speculation by thrift institutions.

400: TRANSPORTATION

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	19.2	20.4	23.4
Changes:			
Highways	---	0.2	*
Mass transit	---	-0.3	-*
Other (net)	---	-*	*
Current estimate	19.2	20.3	23.4
Outlays			
March estimate	17.5	20.5	19.0
Changes:			
Highways	---	0.1	0.2
Mass transit	---	0.4	-*
Aids to railroads	---	-0.2	---
Other	---	*	*
Current estimate	17.5	20.8	19.2

* $50 million or less.

The current estimates of budget authority for this function are below the March estimates by $0.1 billion in 1980 and above them by $0.1 billion in 1981. Estimated outlays are above the March estimates by $0.3 billion in 1980 and by $0.2 billion in 1981.

An increase in Federal aid to highways to cover the cost of repairing roads and bridges damaged by such disasters as the Mount Saint Helens eruptions and the Tampa Bay bridge collapse is primarily responsible for the increase in estimated budget authority in each year. Estimated outlays for Federal aid to highways have increased by $0.1 billion in 1980 and 1981, as a result of these disasters. The 1981 outlay estimate of Federal aid to highways has been increased an additional $0.1 billion due to congressional action on the 1980 supplemental appropriation, which raised the highways obligation limitation.

Estimated outlays for the Urban Mass Transportation Administration have increased by $0.4 billion in 1980 because prior-year obligations are spending out faster than was anticipated in March. This increase is partially offset by decreases in estimated outlays for the Northeast Corridor improvement program and other railroad financing programs.

450: COMMUNITY AND REGIONAL DEVELOPMENT

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	10.0	8.6	9.0
Changes:			
SBA disaster loans	---	0.8	---
Federal emergency management activities	---	0.6	---
Indian affairs	---	-0.3	0.1
Economic development	---	-0.2	---
Rural development and business assistance	---	0.1	---
Other	---	0.2	*
Current estimate	10.0	9.8	9.1
Outlays			
March estimate	9.5	9.0	8.5
Changes:			
SBA disaster loans	---	0.3	0.5
Federal emergency management activities	---	0.3	0.2
Indian affairs	---	-0.3	0.1
Economic development	---	0.1	-0.1
Rural development and business assistance	---	*	0.1
Other	---	0.1	*
Current estimate	9.5	9.5	9.3

---

* $50 million or less.

Increases in budget authority and outlays for Small Business Administration (SBA) disaster loans and the Federal Emergency Management Agency (FEMA) are primarily responsible for the changes in this function since March.

Budget authority requested for SBA disaster loans has increased by $0.8 billion in 1980 primarily because of the following disasters, which have greatly increased the demand for such loans: the eruptions of Mount Saint Helens, civil disorders in Miami, tornadoes in Nebraska, and Hurricane Frederick in Puerto Rico, Alabama, and Mississippi. The increases in budget authority and outlays for emergency management activities are in large part due to the assistance provided recent Cuban/Haitian entrants.

Advanced deposits to the Alaskan Natives claims trust fund by the State of Alaska reduce estimated outlays in 1980 by $0.3 billion. Increased payments to Alaskan Natives from the fund, which directly offset these deposits, are shown in the general government function.

Changes in estimated budget authority and outlays for economic development assistance and rural development programs are due largely to reestimates.

500: EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	32.6	30.7	33.0
Changes:			
Higher education assistance	---	-0.1	---
Other education	---	0.1	*
Employment and training	---	-*	*
Social services	---	-*	*
Current estimate	32.6	30.7	33.0
Outlays			
March estimate	29.7	30.1	30.6
Changes:			
Higher education assistance	---	-0.3	0.1
Other education	---	*	0.1
Employment and training	---	0.1	---
Social services	---	-*	*
Current estimate	29.7	29.9	30.9

---

* $50 million or less.

Budget authority for this function is virtually unchanged from the March estimates, while outlays are decreased slightly in 1980 and increased slightly in 1981. Because the Federal Government provides an interest subsidy for guaranteed student loans, the decline in interest rates since March reduces estimated outlays for higher education assistance by $0.3 billion in 1980. Outlays for this program are estimated to increase by $0.1 billion in 1981 because of increased demand for loans. A number of relatively small changes in other education programs, including increases for disaster relief and assistance for Cuban/Haitian entrants, increase 1980 budget authority and 1981 outlays by an additional $0.1 billion. Revised estimates, based on more recent experience, increase 1980 outlays for employment and training by $0.1 billion.

The following information is provided in fulfillment of the requirement of Section 602 of the Comprehensive Employment and Training Act, and revises information supplied in the Budget Appendix for 1981 in the temporary employment assistance account and in the March update.

-- The unemployment rate for fiscal year 1981 is now estimated to be 8.5%.

-- The number of unemployed in excess of 4% of the labor force is estimated to be 4.82 million.

-- The average cost per year of a public service employment opportunity is estimated to be $10,194.

-- The amount that would be needed to be appropriated to provide public service jobs for 25% of the number of unemployed in excess of 4%, taking into account anticipated budget resources at the beginning of the year, is $13,118 million.

550: HEALTH

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	53.9	59.9	71.1
Changes:			
Medicare:			
Existing law	---	-0.3	-0.9
Proposed legislation	---	---	-*
Medicaid:			
Existing law	---	-0.2	0.3
Proposed legislation	---	---	*
Other	---	0.2	---
Current estimate	53.9	59.6	70.5
Outlays			
March estimate	49.6	56.5	61.9
Changes:			
Medicare:			
Existing law	---	0.7	0.8
Proposed legislation	---	---	0.3
Medicaid:			
Existing law	---	-0.3	0.3
Proposed legislation	---	---	*
Other	---	*	0.1
Current estimate	49.6	56.9	63.4

---

* $50 million or less.

The Administration estimate of 1980 outlays for the health function has increased by $0.5 billion since March. This increase reflects a higher estimate of medicare outlays under existing law that is partly offset by a downward reestimate of outlays for medicaid. For 1981, the current outlay estimate is $1.5 billion higher than the March estimate, primarily due to higher inflation in health care costs, which has increased medicaid program costs and hospital reimbursement per day under medicare.

Congressional inaction on hospital cost containment legislation in 1980 and reestimates have reduced estimated outlay savings under proposed legislation by $0.3 billion. The Administration continues to support passage of this legislation, effective

January 1, 1981, which would save $0.4 billion in 1981 and $. billion in 1982.

The Administration estimates of budget authority for the health function are below the March estimates by $0.3 billion in 1980 and $0.6 billion in 1981. The current estimates of medicare budget authority are lower than the March estimates by $0.3 billion for 1980 and by $0.9 billion for 1981 because of the effect of the revised economic forecast on medicare trust fund receipts. For medicaid, the current estimate of 1980 budget authority reflects a downward reestimate of $0.2 billion, while the current estimate of 1981 budget authority is $0.3 billion above the March estimate due to inflation in health care costs.

600: INCOME SECURITY

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	191.9	223.3	251.6
Changes:			
Social security and railroad retirement	---	-1.3	-3.3
Disabled coal miners benefits	---	-0.1	*
Federal employee retirement and disability	---	-*	0.3
Unemployment compensation	---	0.4	4.4
Food stamps	---	0.3	1.4
Other nutrition programs	---	-0.2	-*
Earned income tax credit	---	-0.4	-0.4
AFDC and other	---	0.3	0.4
Supplemental security income	---	-*	0.2
Other	---	-*	*
Current estimate	191.9	222.2	254.7
Outlays			
March estimate	160.2	190.0	220.1
Changes:			
Social security and railroad retirement	---	-0.1	-0.5
Disabled coal miners benefits	---	-0.1	-*
Federal employee retirement and disability	---	-*	-0.1
Unemployment compensation	---	3.3	9.0
Food stamps	---	0.4	1.4
Other nutrition programs	---	0.2	-*
Earned income tax credit	---	-0.4	-0.4
AFDC and other	---	0.2	0.4
Supplemental security income	---	-*	0.2
Other	---	-*	0.1
Current estimate	160.2	193.5	230.4

---

* $50 million or less.

The current outlay estimates for income security are $3.6 billion above the March estimate for 1980 and $10.3 billion above the March estimate for 1981. These increases are largely due to higher unemployment now forecast for these years.

Compared with the March estimates, major changes in the estimates have been made in the following areas:

-- Budget authority estimates for social security and railroad retirement have decreased by $1.3 billion in 1980 and $3.3 billion in 1981 because of lower than expected tax collections reflecting the revised economic forecast. Reduced revenues will worsen the cash flow problems of the social security trust funds. Outlay estimates have decreased by $0.1 billion in 1980 and $0.5 billion in 1981 largely because of the revised economic forecast, and actual experience to date.

-- Outlay estimates for unemployment compensation have increased by $3.3 billion in 1980 and $9.0 billion in 1981 because of the higher unemployment now expected, and increased trade adjustment assistance payments, primarily for unemployed workers in the automobile industry.

-- Estimated food stamp outlays have increased by $0.4 billion in 1980 and $1.4 billion in 1981 primarily because of an increase in participation rates. Higher food prices also account for a portion of the increase. In addition, outlay estimates for the school lunch program increase by $0.2 billion in 1980 due to a change in the way funds are accounted.

-- The decrease of $0.4 billion in estimated budget authority and outlays in 1980 and 1981 for the earned income tax credit reflects a downward reestimate due to actual experience to date.

-- The increase in estimated outlays of $0.2 billion in 1980 and $0.6 billion in 1981 for aid to families with dependent children (AFDC) and the supplemental security income program is due to the effect of the changed economic forecast, expected higher unemployment, and reestimates based on actual experience to date. The estimates include $0.1 billion in outlays in 1980 and 1981 to reflect the impact of completed congressional action on disability insurance reform and the Adoption Assistance and Child Welfare Act of 1980.

700: VETERANS BENEFITS AND SERVICES

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	20.5	21.2	22.5
Changes:			
Service-connected compensation	---	---	0.1
Education, training, and rehabilitation	---	*	0.1
Medical care	---	-*	0.2
Other	---	-*	-*
Current estimate	20.5	21.2	22.8
Outlays			
March estimate	19.9	20.7	21.4
Changes:			
Service-connected compensation	---	---	0.1
Education, training, and rehabilitation	---	*	0.1
Medical care	---	-*	0.2
Housing	---	0.2	-*
Other	---	-*	*
Current estimate	19.9	20.9	21.8

* $50 million or less.

Budget authority for veterans benefits and services is about the same as estimated in March for 1980 and is above the March estimate by $0.3 billion for 1981. Estimated outlays have increased by $0.2 billion for 1980 and $0.4 billion for 1981.

The increase in estimated outlays for 1980 is in large part due to a reduction in sales of VA-held housing assets (VA mortgages) of $0.2 billion.

An increase in budget authority and outlays for service-connected compensation of $0.1 billion in 1981 reflects higher estimates of the average cost per beneficiary than anticipated in March. An increase in budget authority and outlays for veterans education, training, and rehabilitation of $0.1 billion in 1981 is in large part due to higher estimates of the number of trainees.

Budget authority and outlays for medical care have been revised upward by $0.2 billion in 1981, reflecting a delay in the effective date of proposed legislation requiring health insurers to reimburse the VA for treatment of insured veterans non-service connected disabilities.

750: ADMINISTRATION OF JUSTICE

	Actual 1979	Estimate 1980	Estimate 1981
	($ billions)		
Budget Authority			
March estimate	4.2	4.4	4.3
Changes	---	-*	---
Current estimate	4.2	4.4	4.3
Outlays			
March estimate	4.2	4.6	4.6
Changes	---	*	-*
Current estimate	4.2	4.6	4.6

---

* $50 million or less.

There have been no major changes in this function since March.

800: GENERAL GOVERNMENT

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate..............................	4.4	4.9	4.9
Changes:			
Indian affairs........................	---	0.3	-0.1
Other.................................	---	-*	*
Current estimate...........................	4.4	5.1	4.8
Outlays			
March estimate..............................	4.2	4.8	4.8
Changes:			
Indian affairs........................	---	0.3	-0.1
Other.................................	---	-0.1	*
Current estimate...........................	4.2	5.0	4.7

* $50 million or less.

The current estimates of budget authority and outlays for programs in the general government function are $0.2 billion above the March estimates for 1980 and $0.1 billion below the March estimates for 1981. Estimated 1980 payments to Alaskan Natives from the Alaskan Natives claims trust fund have increased by $0.3 billion since March. Advanced deposits to this fund by the State of Alaska, which directly offset these payments, are shown in the community and regional development function.

850: GENERAL PURPOSE FISCAL ASSISTANCE

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority			
March estimate	8.3	8.8	6.8
Changes:			
Countercyclical and targeted fiscal assistance	---	-0.2	---
Payments to States from Forest Service receipts	---	---	-*
Payments and loans to the District of Columbia	---	*	-0.1
Other	---	*	---
Current estimate	8.3	8.6	6.7
Outlays			
March estimate	8.4	8.8	7.4
Changes:			
Countercyclical and targeted fiscal assistance	---	-0.2	---
Payments to States from Forest Service receipts	---	---	-*
Payments and loans to the District of Columbia	---	*	-0.1
Other	---	*	---
Current estimate	8.4	8.6	7.3

---

* $50 million or less.

The current estimates of outlays and budget authority for this function are below the March estimates in 1980 and in 1981. The $0.2 billion decrease in budget authority and outlays in 1980 for the proposed countercyclical and targeted fiscal assistance program is due to congressional inaction. The $0.1 billion decrease in estimated budget authority and outlays in 1981 for payments to the District of Columbia reflects a reestimate based on actual experience to date. Payments to States from Forest Service receipts are estimated to decline in 1981, reflecting decreased payments as a result of a smaller timber harvest than anticipated in March.

900: INTEREST

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority and Outlays			
March estimate	52.6	64.3	68.4
Changes:			
Interest on the public debt	---	0.1	-0.6
Interest on loans to the Federal Financing Bank	---	0.2	0.1
Interest on refunds of tax collections	---	-0.2	---
Other	---	-0.1	-0.2
Current estimate	52.6	64.3	67.6

Budget authority and outlay estimates for the interest function are about the same as estimated in March for 1980 due to offsetting changes. Higher borrowing requirements and a reduction in interest on loans to the Federal Financing Bank increase estimated budget authority and outlays in 1980 by $0.1 billion and $0.2 billion, respectively. A reestimate of interest on refunds of tax collections, based on collection experience to date, reduces 1980 budget authority and outlays by $0.2 billion.

The 1981 estimates of budget authority and outlays are $0.7 billion lower than the March estimates. This downward reestimate reflects lower interest rates than assumed in March, partially offset by higher borrowing requirements.

The current estimates of interest on the public debt are $74.8 billion in 1980 and $80.4 billion in 1981. These estimates compare to $59.8 billion in 1979.

920: ALLOWANCES

	Estimate ($ billions) 1980	Estimate ($ billions) 1981
Budget Authority		
March estimate.................................	---	1.7
Changes:		
Civilian agency pay raises.................	---	0.2
Furniture rescission.......................	-0.2	---
Assistance to recent alien arrivals........	---	0.1
Current estimate...............................	-0.2	2.0
Outlays		
March estimate.................................	---	1.4
Changes:		
Civilian agency pay raises.................	---	0.2
Furniture rescission.......................	-*	-0.2
Assistance to recent alien arrivals........	---	*
Current estimate...............................	-*	1.4

---

* $50 million or less.

The allowance function includes amounts for Federal civilian agency pay raises, future initiatives, and unforeseen requirements. Budget authority and outlays for this function are below the March estimates in 1980 and above the March estimates in 1981.

The Administration has proposed comprehensive legislation to reform and improve Federal pay-setting procedures for both military and civilian personnel. For civilian employees, the legislative proposal would broaden the principle of comparability and make certain structural changes to bring Federal compensation rates and practices more closely in line with those of the private and non-Federal governmental sectors. Both pay and benefits -- rather than just pay -- would be used to determine comparability. This proposal would require a one-time adjustment in the overall pay raise for white collar and blue collar employees. The January estimate of the overall pay raise was 6.2%. Consistent with this proposal, the current estimate is 7.8%. This reestimate increases 1981 budget authority and outlays for civilian agency pay raises by $226 million and $225 million, respectively. A final decision on the level of the October 1980 pay increase will be made in the late summer after Presidential review of the recommendations of the President's compensation agent, the Federal Employees Compensation Council and the Advisory Committee on Federal Compensation, and after a review of economic conditions at that time.

The 1980 Supplemental Appropriations and Rescission Act provides for a government-wide rescission of furniture purchases, which reduces budget authority by $220 million in 1980 and reduces outlays by $22 million in 1980 and $198 million in 1981. The reduction is shown in the contingency allowance pending determination of an allocation to various agencies as required by the Act. An increase in the 1981 contingency allowance for other requirements of $109 million in budget authority is for the care, maintenance, and resettlement of recent Cuban/Haitian entrants.

950: UNDISTRIBUTED OFFSETTING RECEIPTS

	($ billions)		
	Actual	Estimate	
	1979	1980	1981
Budget Authority and Outlays			
March estimate............................	-18.5	-22.2	-24.9
Changes:			
Offshore oil receipts................	---	---	0.3
Interest received by trust funds.....	---	0.3	0.7
Employer share, employee retirement..	---	*	-0.1
Current estimate..........................	-18.5	-21.9	-24.0

---

* $50 million or less.

The current estimates of undistributed offsetting receipts are below the March estimates for both 1980 and 1981. These changes increase budget authority and outlays in each year. Current estimates of receipts from offshore oil leases are $4.6 billion in 1980 and $5.2 billion in 1981. The $0.3 billion decrease in the 1981 estimate since March is due to reestimates of acreage size and to the new 5-year leasing schedule proposed by the Secretary of the Interior and made final in June 1980. Lower trust fund balances and lower interest rates than were assumed in March are reflected in lower estimates of interest received by trust funds. Current estimates for interest received by trust funds are $11.4 billion for 1980 and $12.5 billion for 1981.

Part 3

LONG-RANGE BUDGET OUTLOOK

This section presents the long-range budget outlook. As required by law, it also contains projected outlays for open-ended programs and fixed costs, and spending from balances of budget authority for non-mandatory programs.

Long-Range Economic Assumptions and the Budget Outlook

Long-Range Economic Goals.--The long-range economic assumptions differ in nature from the short-range economic forecast presented earlier. These assumptions are not forecasts of economic events, but projections that assume progress in moving toward the goals of a more fully employed economy and greater price level stability.

Two sets of longer-range economic assumptions, and budget projections corresponding to each, are presented in this review. Both sets use the same projected rates of inflation but different rates of real GNP growth and unemployment for the 1982-1985 period. One set assumes achievement in 1985 of the 4% unemployment rate goal specified in the "Full Employment and Balanced Growth Act of 1978" (the Humphrey-Hawkins Act). This goal is highly ambitious, requiring real GNP growth of 5-1/2% per year during 1982-1985. The alternative set of economic assumptions is less ambitious, projecting real GNP growth of 4-1/4% per year during 1982-1985 and an unemployment rate of 5-3/4% by the end of 1985.

Table 22.--COMPARISON OF LONG-RANGE ECONOMIC ASSUMPTIONS, 1982-1985

(calendar years; dollar amounts in billions)

	1982	1983	1984	1985
Humphrey-Hawkins Goals				
Gross national product:				
Current dollars	3,210	3,651	4,119	4,610
Constant (1972) dollars:				
Amount	1,491	1,562	1,648	1,739
Percent change, 4th quarter over 4th quarter	5.5	5.5	5.5	5.5
Consumer Price Index (percent change, 4th quarter over 4th quarter)	8.4	7.5	6.6	5.8
Unemployment rate (percent, 4th quarter)	7.3	6.2	5.1	4.0
Alternative Economic Assumptions				
Gross national product:				
Current dollars	3,185	3,580	3,991	4,414
Constant (1972) dollars:				
Amount	1,470	1,532	1,597	1,665
Percent change, 4th quarter over 4th quarter	4.3	4.2	4.3	4.3
Consumer Price Index (percent change, 4th quarter over 4th quarter)	8.4	7.5	6.6	5.8
Unemployment rate (percent, 4th quarter)	7.8	7.1	6.4	5.7

Basic Assumptions.--The long-range receipts projections presented in this section are consistent with the economic projections and with continuation of current tax laws as modified by the Administration's proposals. The budget authority and outlay estimates are not precise forecasts of future budget levels; nor are they intended as detailed, final recommendations. Instead, they indicate the degree to which resources would be committed by the continuation during 1982-1985 of existing and currently proposed programs at the program levels recommended for 1980 and 1981, and planned for 1982 and 1983.

Budget Projections under Humphrey-Hawkins Goals.--As shown in Table 23, outlays consistent with the Humphrey-Hawkins goals are projected to rise $303.4 billion, from $633.8 billion in 1981 to $937.2 billion in 1985. Receipts under these economic goals are projected to increase more rapidly, from $604.0 billion in 1981 to $1113.6 billion in 1985.

Table 23.--THE BUDGET OUTLOOK
UNDER HUMPHREY-HAWKINS GOALS, 1981-1985
(in billions of dollars)

	1981	1982	1983	1984	1985
Receipts.....................	604.0	715.3	835.3	965.6	1113.6
Outlays......................	633.8	702.9	788.7	870.0	937.2
Surplus or deficit (-)....	-29.8	12.4	46.7	95.5	176.4

Thus, under these assumptions, the budget is projected to move into surplus in 1982, with larger surpluses (or budget margins) in subsequent years. It should be strongly emphasized, however, that the budget margins projected after 1981 do not imply that budget surpluses of such magnitude will in fact occur in those years. It is quite likely that a tax cut will be desirable in 1981. But it is not appropriate to propose one now.

Projections of receipts by source and the composition of budget outlays under the Humphrey-Hawkins goals are shown in Table 24.

Table 24.--BUDGET RECEIPTS AND OUTLAYS
UNDER HUMPHREY-HAWKINS GOALS, 1981-1985
(in billions of dollars)

	1981	1982	1983	1984	1985
Budget receipts by source					
Individual income taxes...	278.2	327.4	395.1	472.8	558.8
Corporation income taxes..	66.4	74.6	90.2	107.7	126.5
Social insurance taxes and contributions............	184.5	214.2	241.5	268.0	305.6
Excise taxes..............	48.7	70.5	75.8	80.3	83.6
Other.....................	26.3	28.7	32.8	36.7	39.1
Total budget receipts...........	604.0	715.3	835.3	965.6	1113.6
Composition of budget outlays					
National defense..........	157.5	176.9	199.5	223.4	248.0
Nondefense:					
Payments for individuals...........	313.8	344.4	388.3	436.0	473.0
Net interest...........	55.1	58.2	59.2	58.0	59.4
All other..............	107.4	123.4	141.6	152.6	156.9
Subtotal, Nondefense	476.3	526.0	589.1	646.6	689.2
Total budget outlays	633.8	702.9	788.7	870.0	937.2

Budget Projections Under Alternative Economic Assumptions.--The Administration continues to support the goals of the Full Employment and Balanced Growth Act. Indeed, the Administration's youth initiative, strong support of programs for the poor and disadvantaged, commitment to programs that increase productivity, and anti-inflation efforts will further the objectives of this Act. However, current economic conditions indicate that the unemployment goals will be difficult to attain and are an optimistic assumption about future economic performance. We will, of course, strive to achieve the Humphrey-Hawkins goals. However, prudent multi-year budget planning requires that longer-range budget projections include consideration of alternate economic assumptions. As noted above, these assumptions reflect lower real growth and higher unemployment in 1982-1985 than under the Humphrey-Hawkins goals.

Budget estimates and projections based on the alternative economic assumptions are shown in the following table. Receipts are projected to increase by an average of 15% per year from 1981 to 1985, rising from $604.0 billion to $1052.7 billion. Over the same period, outlays are projected to rise by an average of 10.5% per year, from $633.8 billion to $945.9 billion. These projections show a deficit of $29.8 billion in 1981, but surpluses thereafter.

Table 25.--THE BUDGET OUTLOOK
UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS, 1981-1985

	1981	1982	1983	1984	1985
Receipts....................	604.0	711.4	819.3	930.4	1052.7
Outlays.....................	633.8	705.5	792.3	876.1	945.9
Surplus or deficit (-)..	-29.8	5.9	26.0	54.3	106.9

In comparison with the estimates and projections under the Humphrey-Hawkins goals, smaller surpluses result under the alternative economic assumptions. These differences are shown in Table 26.

Table 26.--DIFFERENCES IN BUDGET PROJECTIONS UNDER HUMPHREY-HAWKINS AND ALTERNATIVE ECONOMIC ASSUMPTIONS, 1981-1985
(in billions of dollars)

	1981	1982	1983	1984	1985
Receipts					
Receipts under Humphrey-Hawkins goals................	604.0	715.3	835.3	965.6	1113.6
Effect of alternative economic assumptions.....	---	-3.9	-17.1	-35.2	-60.9
Receipts under alternative economic assumptions........	604.0	711.4	818.3	930.4	1052.7
Outlays					
Outlays under Humphrey-Hawkins goals................	633.8	702.9	788.7	870.0	937.2
Effect of alternative economic assumptions.....	---	2.6	3.6	6.1	8.7
Outlays under alternative economic assumptions........	633.8	705.5	792.3	876.1	945.9

Additional information on projected receipts, budget authority and outlays under the alternative economic assumptions is provided in the summary tables.

Projections of Outlays for Open-Ended Programs and Fixed Costs.--Outlay projections for open-ended programs and fixed costs are shown in Table 36, as required by Section 221(b) of the Legislative Reorganization Act of 1970.

These projections indicate that, under existing legislation and the alternative economic assumptions, payments for individuals are estimated to grow by roughly 8.5% a year from 1981 to 1985. Outlays for net interest are projected to increase through 1983, to decline in 1984, and to increase in 1985. Outlays for other open-ended programs and fixed costs are projected to increase somewhat during the 1981-1985 period. Total open-ended programs and fixed costs are projected to comprise 56% of total budget outlays in 1985, a decrease from the 1981 share of 60%.

Spending from Balances of Budget Authority Available at the End of Fiscal Year 1981: Non-Mandatory Programs.--Section 221(b) of the Legislative Reorganization Act of 1970 amended the Budget and Accounting Act of 1921 to require that the President transmit to the Congress "summaries of estimated expenditures, in fiscal years following such ensuing fiscal year [1981, this year], of balances carried over from such ensuing fiscal year." Table 37 presents these estimates.

The current estimate of the balances at the end of fiscal year 1981 for programs that have controllable outlays is $325.4 billion. About $20.9 billion of this total is in guarantee and insurance program balances, very little of which is expected ever to be spent. The spending pattern from the balances in other programs, which amount to $304.5 billion, is fairly consistent among the programs. The bulk of the spending from balances takes place in 1982, and declines rapidly thereafter. About 43% is expected to be spent in 1982 and approximately 20% in 1983. About 20% ($61.1 billion) is expected to remain unexpended at the end of fiscal year 1985. An estimated $4.6 billion of the 1981 end-of-year balances is expected to expire (without being spent) during fiscal years 1982 through 1985.

Table 27.--LONG-RANGE ECONOMIC ASSUMPTIONS UNDER HUMPHREY-HAWKINS GOALS, 1982-1985
(calendar years; dollar amounts in billions)

	1982	1983	1984	1985
Major Economic Indicators				
Gross national product, (percent change, 4th quarter over 4th quarter):				
Current dollars	14.3	13.4	12.5	11.6
Constant (1972) dollars	5.5	5.5	5.5	5.5
GNP deflator (percent change, 4th quarter over 4th quarter)	8.4	7.5	6.6	5.8
Consumer Price Index (percent change, 4th quarter over 4th quarter	8.4	7.5	6.6	5.8
Unemployment rate (percent, 4th quarter)	7.3	6.2	5.1	4.0
Annual Economic Assumptions				
Gross national product:				
Current dollars:				
Amount	3,210	3,651	4,119	4,610
Percent change, year over year	13.8	13.8	12.8	11.9
Constant (1972) dollars:				
Amount	1,481	1,562	1,648	1,739
Percent change, year over year	4.5	5.5	5.5	5.5
Incomes:				
Personal income	2,628	2,969	3,322	3,688
Wages and salaries	1,645	1,857	2,085	2,327
Corporate profits	270	325	386	450
Price level:				
GNP deflator:				
Level (1972=100), annual average	216.8	233.7	249.9	265.1
Percent change, year over year	8.8	7.8	6.9	6.1
Consumer Price Index 1/:				
Level (1967=100), annual average	295.0	318.1	340.2	360.9
Percent change, year over year	8.9	7.8	6.9	6.1

See footnotes at end of table.

Table 27 (continued)

	1982	1983	1984	1985
Unemployment rates:				
Total, annual average	7.7	6.6	5.5	4.4
Insured, annual average 2/	4.2	3.4	2.6	1.9
Federal pay raise, October (percent) 3/	8.5	8.0	7.5	7.0
Interest rate, 91-day Treasury bills (percent) 4/	9.2	8.5	7.6	5.8

1/ The index shown is the CPI for urban wage earners and clerical workers. There are now two versions of the CPI published. One estimates the cost of living for wage earners and clerical workers in urban areas; the other, more recently developed, is more comprehensive, covering all urban dwellers. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs.

2/ This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.

3/ Pay raises become effective in October of each year -- the first month of the new fiscal year. Thus, the October 1980 pay raise will set new pay scales that will be in effect during fiscal year 1981.

4/ Average rate on new issues within period. These projections assume, by convention, that interest rates are linked to the rate of inflation. They do not represent a forecast of interest rates.

Table 28.--ALTERNATIVE LONG-RANGE ECONOMIC ASSUMPTIONS, 1982-1985
(calendar years; dollar amounts in billions)

	1982	1983	1984	1985
Major Economic Indicators				
Gross national product, (percent change, 4th quarter over 4th quarter):				
Current dollars	13.0	12.1	11.1	10.3
Constant (1972) dollars	4.3	4.2	4.3	4.3
GNP deflator (percent change, 4th quarter over 4th quarter)	8.4	7.5	6.6	5.8
Consumer Price Index (percent change, 4th quarter over 4th quarter	8.4	7.5	6.6	5.8
Unemployment rate (percent, 4th quarter)	7.8	7.1	6.4	5.7
Annual Economic Assumptions				
Gross national product:				
Current dollars:				
Amount	3,185	3,580	3,991	4,414
Percent change, year over year	12.9	12.4	11.5	10.6
Constant (1972) dollars:				
Amount	1,470	1,532	1,597	1,665
Percent change, year over year	3.8	4.2	4.3	4.3
Incomes:				
Personal income	2,614	2,928	3,241	3,562
Wages and salaries	1,635	1,822	2,020	2,225
Corporate profits	260	303	349	395
Price level:				
GNP deflator:				
Level (1972=100), annual average	216.8	233.7	249.9	265.1
Percent change, year over year	8.8	7.8	6.9	6.1
Consumer Price Index 1/:				
Level (1967=100), annual average	295.0	318.1	340.2	360.9
Percent change, year over year	8.9	7.8	6.9	6.1

See footnotes at end of table.

Table 28 (continued)

	1982	1983	1984	1985
Unemployment rates:				
Total, annual average	8.0	7.3	6.6	6.0
Insured, annual average 2/	4.6	4.0	3.4	2.9
Federal pay raise, October (percent) 3/	8.5	8.0	7.5	7.0
Interest rate, 91-day Treasury bills (percent) 4/	9.2	8.5	7.6	6.8

1/ The index shown is the CPI for urban wage earners and clerical workers. There are now two versions of the CPI published. One estimates the cost of living for wage earners and clerical workers in urban areas; the other, more recently developed, is more comprehensive, covering all urban dwellers. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living increases for indexed Federal programs.

2/ This indicator measures unemployment under State regular unemployment insurance as a percentage of covered employment under that program. It does not include recipients of extended benefits under that program.

3/ Pay raises become effective in October of each year -- the first month of the new fiscal year. Thus, the October 1980 pay raise will set new pay scales that will be in effect during fiscal year 1981.

4/ Average rates on new issues within period. These projections assume, by convention, that interest rates are linked to the rate of inflation. They do not represent a forecast of interest rates.

Table 29.--BUDGET RECEIPTS BY MAJOR SOURCE, 1979-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

	Actual	Current Estimate				Projection	
	1979	1980	1981	1982	1983	1984	1985
Individual income taxes..................	217.8	240.7	278.2	325.6	386.3	453.4	523.1
Corporation income taxes.................	65.7	65.5	66.4	73.2	85.4	98.2	111.5
Social insurance taxes and contributions	141.6	160.5	184.5	213.5	238.5	262.7	297.2
Excise taxes.............................	18.7	25.4	48.7	70.5	75.6	80.1	83.1
Estate and gift taxes....................	5.4	6.1	6.3	6.8	7.7	8.6	9.5
Customs duties...........................	7.4	7.0	7.5	7.9	8.3	8.8	9.2
Miscellaneous receipts...................	9.2	12.7	12.5	13.9	16.4	18.5	19.0
Total budget receipts..............	465.9	517.9	604.0	711.4	818.3	930.4	1052.7

Table 30.--ESTIMATED EFFECT OF ADMINISTRATIVE ACTIONS AND PROPOSED LEGISLATION ON RECEIPTS, 1980-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

	Current Estimate				Projection	
	1980	1981	1982	1983	1984	1985
Receipts under current law......................	517.9	591.6	687.3	791.0	898.1	1011.2
Extension of airport and airway trust fund taxes......................................	---	0.8	1.0	1.1	1.2	1.4
Extension of highway trust fund taxes.......	---	---	---	---	---	4.1
Receipts on a current services basis...........	517.9	592.5	688.3	792.2	899.3	1016.6
Proposed legislation and administrative actions other than extensions:						
Excise tax on gasoline and diesel fuels..	---	3.5	13.1	15.0	16.8	18.0
Withholding of taxes on interest and dividend income.........................	---	3.4	2.5	2.8	3.1	3.5
Cash management initiatives..............	---	1.2	3.2	1.4	0.8	0.7
Railroad retirement tax increase.........	---	0.3	0.3	0.3	0.3	0.3
Tax-exempt mortgage bonds................	---	0.6	2.1	4.4	7.6	13.3
Oil and hazardous substance cleanup......	---	0.2	0.3	0.4	0.4	-*
Tax treatment of independent contractors.	---	0.6	0.6	0.7	0.9	1.1
Foreign tax credit.......................	---	1.4	0.5	0.6	0.6	0.6
Other....................................	---	0.4	0.5	0.5	0.5	0.6
Total, Proposed legislation and administrative actions other than extensions................	---	11.5	23.1	26.1	31.1	36.2
Total budget receipts..........................	517.9	604.0	711.4	818.3	930.4	1052.7

---

* $50 million or less.

Table 31.--COMPOSITION OF BUDGET OUTLAYS, 1979-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(dollar amounts in billions)

	Actual	Current Estimate				Projection	
	1979	1980	1981	1982	1983	1984	1985
National defense:							
Direct Federal payments for individuals	10.3	11.8	13.5	15.9	17.7	19.5	21.2
Grants to States and localities	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other	107.3	123.7	143.9	161.0	181.8	203.9	226.7
Subtotal, National defense	117.7	135.6	157.5	176.9	199.5	223.4	248.0
Nondefense:							
Direct Federal payments for individuals	198.7	235.5	276.1	304.8	345.6	391.3	426.1
Payments for individuals through States and localities	28.8	34.2	37.7	42.2	46.4	50.0	55.6
All other grants to States and localities	54.0	56.8	54.4	58.3	62.4	64.7	65.7
Net interest	42.6	52.9	55.1	58.2	59.2	58.0	59.4
Other	51.9	63.8	53.0	65.1	79.1	87.8	90.2
Subtotal, Nondefense	376.0	443.2	476.3	528.6	592.7	652.7	697.9
Total	493.7	578.8	633.8	705.5	792.3	876.1	945.9

Table 31 (continued)

Percent of Total Outlays	Actual 1979	Current Estimate 1980	1981	1982	1983	Projection 1984	1985
National defense:							
Direct Federal payments for individuals........	2.1	2.0	2.1	2.2	2.2	2.2	2.2
Grants to States and localities................	*	*	*	*	*	*	*
Other..	21.7	21.4	22.7	22.8	22.9	23.3	24.0
Subtotal, National defense................	23.8	23.4	24.9	25.1	25.2	25.5	26.2
Nondefense:							
Direct Federal payments for individuals........	40.3	40.7	43.6	43.2	43.6	44.7	45.0
Payments for individuals through States and localities..............................	5.8	5.9	6.0	6.0	5.9	5.8	5.9
All other grants to States and localities......	10.9	9.8	8.6	8.3	7.9	7.4	7.1
Net interest...................................	8.6	9.1	8.7	8.3	7.5	6.6	6.3
Other..	10.5	11.0	8.4	9.2	10.0	10.0	9.5
Subtotal, Nondefense......................	76.2	76.6	75.1	74.9	74.8	74.5	73.8
Total.....................................	100.0	100.0	100.0	100.0	100.0	100.0	100.0

---

* 0.05% or less.

Table 32.--BUDGET OUTLAYS BY FUNCTION, 1979-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

	Actual	Current Estimate				Projection	
	1979	1980	1981	1982	1983	1984	1985
National defense	117.7	135.6	157.5	176.9	199.5	223.4	248.0
International affairs	6.1	10.9	10.3	10.7	11.3	12.3	13.3
General science, space and technology	5.0	5.7	6.2	7.0	7.3	7.2	7.1
Energy	6.9	6.5	7.2	10.4	15.2	15.6	12.7
Natural resources and environment	12.1	13.7	13.1	13.7	14.2	14.4	14.7
Agriculture	6.2	5.8	2.2	4.3	4.3	4.9	6.0
Commerce and housing credit	2.6	8.3	0.7	2.4	2.7	2.9	2.5
Transportation	17.5	20.8	19.2	21.6	23.9	24.9	25.9
Community and regional development	9.5	9.5	9.3	9.2	9.4	9.8	10.0
Education, training, employment, and social services	29.7	29.9	30.9	34.0	36.6	38.5	40.0
Health	49.6	56.9	63.4	71.7	80.6	90.1	100.2
Income security	160.2	193.5	230.4	253.7	274.7	296.3	320.1
(Social security)	(102.6)	(117.8)	(137.8)	(156.2)	(175.0)	(193.4)	(211.9)
(Other)	(57.6)	(75.7)	(92.6)	(97.5)	(99.7)	(102.9)	(108.2)
Veterans benefits and services	19.9	20.9	21.8	23.1	24.6	26.1	27.3
Administration of justice	4.2	4.6	4.6	4.6	4.6	4.7	4.8
General government	4.2	5.0	4.7	5.0	5.0	5.3	5.2
General purpose fiscal assistance	8.4	8.6	7.3	6.8	6.4	6.5	6.6
Interest	52.6	64.3	57.6	71.5	72.9	71.8	73.7
Allowances	---	-*	1.4	5.8	26.3	49.0	56.3
Undistributed offsetting receipts	-18.5	-21.9	-24.0	-27.0	-27.5	-27.8	-28.5
Total budget outlays	493.7	578.8	633.8	705.5	792.3	876.1	945.9
MEMORANDUM							
Outlays of off-budget Federal entities	12.4	16.1	21.7	16.2	13.7	11.7	15.7

---

* $50 million or less.

Table 33.--BUDGET OUTLAYS BY AGENCY, 1979-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

	Actual	Current Estimate				Projection	
	1979	1980	1981	1982	1983	1984	1985
Legislative branch	1.1	1.3	1.3	1.4	1.4	1.4	1.4
The Judiciary	0.5	0.6	0.6	0.7	0.7	0.7	0.8
Executive Office of the President	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Funds appropriated to the President	2.6	7.6	6.0	5.9	6.2	6.7	7.2
Agriculture	20.6	25.7	20.8	26.7	28.1	30.0	31.9
Commerce	4.1	3.8	2.9	3.1	3.3	3.5	3.7
Defense-Military	115.0	132.6	153.9	173.0	195.3	218.8	243.1
Defense-Civil	2.9	3.5	3.1	3.5	3.6	3.5	3.6
Education	10.9	12.5	13.3	15.3	16.4	17.3	18.4
Energy	7.9	6.5	8.4	11.7	16.8	17.7	14.9
Health and Human Services	170.3	194.1	224.1	252.2	281.5	309.2	339.3
Housing and Urban Development	9.2	12.6	11.9	13.9	15.9	17.6	19.4
Interior	4.1	4.0	4.0	4.3	4.6	4.9	5.2
Justice	2.5	2.7	2.6	2.5	2.5	2.4	2.5
Labor	22.6	29.6	39.4	37.7	33.8	32.9	31.9
State	1.5	1.9	2.2	2.4	2.5	2.6	2.8
Transportation	15.5	18.6	17.7	20.1	22.4	23.3	24.1
Treasury	65.0	76.5	78.3	81.8	82.5	81.7	83.5
Environmental Protection Agency	4.8	5.7	5.5	5.7	5.9	6.1	6.3
National Aeronautics and Space Administration	4.2	4.9	5.2	6.0	6.1	5.9	5.7
Veterans Administration	19.9	20.8	21.7	23.0	24.5	26.1	27.3
Office of Personnel Management	12.7	14.9	17.0	19.5	21.9	24.3	26.6
Other independent agencies	14.1	20.3	16.5	16.2	16.6	17.1	17.7
Allowances	---	-*	1.4	6.0	27.1	49.0	57.1
Undistributed offsetting receipts	-18.5	-21.9	-24.0	-27.0	-27.5	-27.8	-28.5
Total budget outlays	493.7	578.8	633.8	705.5	792.3	876.1	945.9

---

* $50 million or less.

Table 34.--BUDGET AUTHORITY BY FUNCTION, 1979-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

	Actual	Current Estimate				Projection	
	1979	1980	1981	1982	1983	1984	1985
National defense....................................	127.8	143.8	171.5	194.0	218.0	243.2	270.2
International affairs...............................	8.7	13.4	23.5	15.0	15.3	17.2	18.5
General science, space and technology...............	5.4	6.1	6.6	7.1	7.3	7.0	6.9
Energy..	7.4	37.5	7.2	18.6	11.0	11.6	9.7
Natural resources and environment...................	13.2	13.3	12.6	14.4	15.2	15.5	15.5
Agriculture...	9.3	5.1	5.4	5.0	5.1	5.5	5.2
Commerce and housing credit.........................	5.9	10.4	5.6	6.1	6.5	6.9	6.8
Transportation......................................	19.2	20.3	23.4	23.5	25.9	26.6	27.6
Community and regional development..................	10.0	9.8	9.1	9.7	10.1	10.5	10.6
Education, training, employment, and social services....................................	32.6	30.7	33.0	35.0	38.1	40.1	41.5
Health..	53.9	59.6	70.5	82.2	93.2	104.8	118.6
Income security.....................................	191.9	222.2	254.7	287.2	307.3	327.8	359.7
(Social security)...................................	(100.6)	(115.5)	(129.2)	(147.8)	(164.3)	(181.4)	(208.0)
(Other)...	(91.3)	(106.7)	(125.5)	(139.4)	(143.0)	(146.4)	(151.8)
Veterans benefits and services......................	20.5	21.2	22.8	23.8	25.1	26.4	27.7
Administration of justice...........................	4.2	4.4	4.3	4.4	4.6	4.7	4.8
General government..................................	4.4	5.1	4.8	5.1	5.0	5.2	5.3
General purpose fiscal assistance...................	8.3	8.6	6.7	6.8	6.4	6.5	6.6
Interest..	52.6	64.3	67.6	71.5	72.9	71.8	73.7
Allowances..	---	-0.2	2.0	6.9	27.8	50.7	58.0
Undistributed offsetting receipts...................	-18.5	-21.9	-24.0	-27.0	-27.5	-27.8	-28.5
Total budget authority..............................	556.7	653.7	707.2	790.4	867.3	954.2	1037.4
MEMORANDUM							
Budget authority of off-budget Federal entities...	16.3	22.8	27.7	27.0	28.8	19.1	37.7

Table 35.--BUDGET AUTHORITY BY AGENCY, 1979-1985
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

	Actual	Current Estimate				Projection	
	1979	1980	1981	1982	1983	1984	1985
Legislative branch	1.1	1.3	1.3	1.5	1.3	1.4	1.4
The Judiciary	0.5	0.6	0.7	0.7	0.7	0.8	0.8
Executive Office of the President	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Funds appropriated to the President	5.9	11.0	14.0	7.0	7.4	8.4	8.8
Agriculture	24.5	25.3	25.4	28.2	29.7	31.3	31.9
Commerce	2.6	3.1	2.9	3.3	3.7	3.8	3.9
Defense-Military	125.0	140.8	167.8	190.0	213.7	238.5	265.3
Defense-Civil	2.8	3.3	2.9	4.0	4.0	3.9	4.0
Education	12.6	13.4	15.1	16.1	17.4	18.4	19.5
Energy	10.3	11.0	10.6	22.0	14.5	15.1	12.5
Health and Human Services	172.8	195.3	222.9	254.3	283.5	311.8	353.7
Housing and Urban Development	31.1	35.6	40.3	44.5	46.2	48.7	50.9
Interior	4.7	4.6	4.1	4.4	4.8	5.1	5.6
Justice	2.5	2.5	2.2	2.3	2.4	2.4	2.5
Labor	28.6	28.3	35.7	41.7	40.3	39.8	39.2
State	1.7	2.1	2.4	2.5	2.6	2.7	2.8
Transportation	17.2	18.4	21.9	21.9	24.3	24.9	25.8
Treasury	64.7	90.3	78.2	82.2	82.9	82.0	83.8
Environmental Protection Agency	5.4	4.7	5.3	5.8	6.4	6.7	6.5
National Aeronautics and Space Administration	4.5	5.2	5.5	5.9	6.1	5.7	5.5
Veterans Administration	20.5	21.2	22.8	23.8	25.0	26.4	27.6
Office of Personnel Management	21.0	24.5	26.6	28.4	30.0	31.5	32.9
Other independent agencies	14.9	33.3	20.6	18.9	19.4	21.0	22.3
Allowances	---	-0.2	2.0	7.7	28.6	51.5	58.8
Undistributed offsetting receipts	-18.5	-21.9	-24.0	-27.0	-27.5	-27.8	-28.5
Total budget authority	556.7	653.7	707.2	790.4	867.3	954.2	1037.4

Table 36.--PROJECTIONS OF OUTLAYS FOR OPEN-ENDED PROGRAMS AND FIXED COSTS, 1981-1985*
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(in billions of dollars)

Open-Ended Programs and Fixed Costs	Estimate			Projection	
	1981	1982	1983	1984	1985
Payments for individuals:					
Social security and railroad retirement	143.1	161.8	181.1	199.8	218.6
Federal employees retirement and insurance	39.5	43.6	48.0	52.2	56.3
Unemployment assistance	27.2	25.3	20.8	19.3	18.0
Medical care	55.1	63.9	73.6	84.4	95.4
Assistance to students	2.0	1.6	1.3	1.1	1.0
Housing payments	6.4	7.6	9.0	10.5	12.2
Food and nutrition assistance	14.3	16.3	17.4	18.2	18.9
Public assistance and related programs	20.9	21.9	23.5	23.1	24.8
All other uncontrollable payments for individuals	2.5	2.6	2.7	2.8	2.8
Subtotal, Payments for individuals	311.0	344.7	377.5	411.9	449.7
Net interest	55.7	58.9	60.2	59.4	61.3
General revenue sharing	5.1	4.6	4.6	4.6	4.6
Other open-ended programs and fixed costs	9.6	9.5	9.9	10.9	11.5
Total, Open-ended programs and fixed costs	381.4	417.7	452.2	486.8	527.1

---

* This table is supplied pursuant to the requirements of Section 221(b) of the Legislative Reorganization Act of 1970 (P.L. 91-510).

Table 37.--ESTIMATED SPENDING FROM END OF FISCAL YEAR 1981 BALANCES OF BUDGET AUTHORITY: NON-MANDATORY PROGRAMS
(UNDER ALTERNATIVE ECONOMIC ASSUMPTIONS)
(In billions of dollars)

	Federal Guarantee and Insurance Programs: Reserves for Losses, and Standby and Backup Authority	Other Unexpended Balances, September 30, 1981	Total
Total balances, end of 1981 (current estimate)................	20.9	304.5	325.4
Spending from balances in:			
1982..........................	0.4	131.5	132.0
1983..........................	0.3	60.9	61.2
1984..........................	0.1	29.5	29.6
1985..........................	0.1	16.9	17.0
Expiring balances, 1982 through 1985......................	---	4.6	4.6
Unexpended balances as of the end of 1985..................	19.9	61.1	80.9

For use at 10 a.m.,
July 22, 1980

Board of Governors of the Federal Reserve System

Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 22, 1980

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 22, 1980

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

TABLE OF CONTENTS

Page

Letter of Transmittal

Chapter 1. The Outlook for the Economy and Monetary Policy Objectives

Section 1. The Outlook for the Economy 1

Section 2. Monetary Policy Objectives 5

Section 3. Money and Credit Growth in 1980 and 1981 7

Section 4. The Administration's Short-term Economic Goals and the Relationship of Federal Reserve Objectives to those Goals 16

Chapter 2. A Review of Recent Economic and Financial Developments

Section 1. Economic Activity During the First Half of 1980 18

Section 2. Labor Markets and Capacity Utilization 30

Section 3. Prices, Wages, and Productivity 33

Section 4. Financial Developments During the First Half of 1980 36

CHAPTER 1

THE OUTLOOK FOR THE ECONOMY AND MONETARY POLICY OBJECTIVES

SECTION 1. THE OUTLOOK FOR THE ECONOMY

The economy moved into recession in the first half of this year. A cyclical downturn had been widely anticipated for some time, but the decline in spending, output, and employment, once under way, has been steeper than most analysts had foreseen. The second quarter decrease in real gross national product, at an annual rate of about 9 percent according to the Commerce Department's preliminary estimate, was considerably sharper than in the initial quarters of other postwar recessions.

The slump in activity has been most pronounced in the housing and auto industries--the latter sector being adversely affected by structural problems as well as by general cyclical pressures. But the decline has not been limited to these sectors. Retail sales excluding autos have dropped considerably since January, and business outlays for equipment and new construction also have fallen.

The very sharp curtailment of spending on houses and consumer goods and services in the current downturn probably is attributable in large part to the cumulative effect of inflation on consumers' financial well-being. Real disposable personal income was virtually flat in 1979 and has declined appreciably this year. Earlier, consumers had reduced their rate of saving in the face of shortfalls in real income in an effort to maintain consumption standards and in anticipation of inflation. This was accomplished by further rapid growth in installment and mortgage credit in the late stages of the recent expansion, but with the result that debt service burdens--which already were at high levels historically--continued to climb. Sharply higher interest rates and generally more stringent credit terms in late 1979 and early 1980 acted as additional deterrents to spending, encouraging households in their efforts to reduce debt and to rebuild savings.

The falloff in final sales has caused businessmen to spend more cautiously. This tendency has been reinforced by financial factors as well. The liquidity position of businesses had deteriorated appreciably during the expansion, particularly in the latter stages when there was a surge in short-term borrowing; many firms now are making strong efforts to restructure balance sheets.

The unexpected rapidity of the current downturn thus far has led analysts to reassess their view of the prospects for economic activity in the period ahead. Significant disagreement has arisen with regard to whether recovery will be prompt and strong, with the recent relaxation of credit market conditions encouraging a resumption of normal spending patterns, or whether the cyclical adjustment will be prolonged and the subsequent upturn possibly sluggish. The experience of the past year or so has demonstrated the hazards of forecasting, and the uncertainties at the present time clearly are substantial. Much will depend, for example, on the perceptions of businessmen about the longer-range prospects for demand and the attractiveness of investment, the response of consumers to the 1981 model-year automobiles, and the strength of the rebound in housing that may develop in the wake of the recent easing in mortgage market conditions.

There are signs that the contraction in some sectors may be nearing an end, but these are far from conclusive. Retail sales in June turned up slightly after four months of sharp decline; in the first ten days of July auto sales were at the strongest pace in three months. Housing starts and sales of new homes strengthened in the most recent months for which data are available.

In reflection of the prevailing uncertainties, there is a considerable range of views among the members of the Federal Open Market Committee regarding the movement of major economic variables over the remainder of the year. Most of the members believe that the recession probably will persist into the fourth quarter, with a cumulative net drop in real GNP less than that in the downslide of 1973-75. Although the decline should slow in the months ahead, employment may be cut back further, and the unemployment rate could rise beyond 8-1/2 percent by year-end. The increasing slack in labor markets and in industrial capacity utilization should at the same time help to moderate inflationary pressures.

The table below presents ranges for key economic variables that generally encompass the judgments of the individual FOMC members about the probable performance of the economy this year and in 1981.

	Actual	Projected	
	1979	1980	1981
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.9	5 to 7-1/2	8-1/2 to 11-1/2
Real GNP	1.0	-5 to -2-1/2	1/2 to 3
Implicit GNP deflator	8.9	9 to 10	7-3/4 to 9-1/2
Average level in fourth quarter			
Unemployment Rate (percent)	5.9	8-1/2 to 9-1/4	8 to 9-1/4

The outlook for 1981 is especially uncertain at the current time. Economic and financial developments over the next six months should lay the groundwork for the recovery anticipated in 1981. But, in addition, any actions taken in the fiscal arena would have an impact on the path of recovery. The projections presented in the table, which do not assume a tax cut in the next year, indicate a turnaround in economic activity—although there is a considerable range of views concerning the potential strength of the recovery. On balance, the forecast is for a moderate rebound in real GNP, accompanied by some further slackening in the pace of inflation. Unemployment, however, is likely to remain high throughout the year.

Should there be a tax cut in 1981, the impact on economic performance will, of course, depend on its timing and composition. There is the distinct—and very troubling—possibility that a poorly designed tax reduction, or one not coupled with adequate restraint on the expenditure side, might give rise to added inflationary and financial pressures that would in time dissipate the beneficial short-term effects of the fiscal stimulus. Any indication that the Congress and the Administration were moving away from a commitment to rigorous fiscal discipline would run the risk of reinvigorating the inflationary expectations that have played such a major role in the economy's difficulties. The Committee thus feels it important that the question of a tax cut be approached cautiously; if a tax cut ultimately is enacted, it should be carefully structured to enhance the productive potential of our economy and to yield the greatest relief from cost and price pressures over the longer run.

SECTION 2. MONETARY POLICY OBJECTIVES

The task for monetary policy—and for stabilization policy generally—in the current circumstances obviously is a difficult one. Recession naturally summons forth calls for stimulus to aggregate demand. The prevailing high level of unemployment, and the exceptional weakness apparent in particular industries and sectors of our economy, certainly must be given careful consideration in the formulation of public policy. But caution must be exercised in the application of any broad countercyclical stimulus, especially in the present environment of persistent inflationary pressures. Indeed, there is no clearer lesson from the experience of the past decade and a half than that excessive stimulus is detrimental to the objective of achieving and sustaining noninflationary, balanced growth.

A primary and continuing goal of monetary policy must be to curb the accelerating inflationary cycle. It now appears that some progress is, beginning to be made in that direction. Price increases have slowed considerably from the pace of early in the year, in part reflecting some relief in the food and energy sectors, but also as a result of the drop in demand pressures. In addition, recent attitudinal surveys point to a reduction in inflationary expectations. The continuation of this trend in expectations will result in a greatly improved economic and financial environment, one more conducive to long-term growth. We already have witnessed one benefit of an easing of inflationary fears: a substantial decline in long-term interest rates from their highs earlier this year and a revitalization of the bond markets. The Federal Reserve's pursuit of a policy of monetary restraint—evidenced this year by a moderation of money growth—has been an important factor in this turn in expectations; a sustained commitment to the attainment of noninflationary rates of money and credit growth is essential if this progress is to be extended.

Despite the improvement that has occurred, however, inflationary forces are far from subdued. The past years have left a legacy of adverse cost trends that will not be reversed quickly. Moreover, more extreme inflationary expectations easily could be reignited. In establishing its plans for growth in the monetary aggregates, the Federal Reserve will continue to place high priority on reducing inflation, believing that this is essential to fostering a sound and sustained recovery. Over the long term, a reduction in the underlying rate of inflation is essential for a strong U.S. economy, for encouraging the saving we will need to finance adequate capital investment, and for maintaining the position of the dollar in international markets.

But it is clear also that if inflation is to be restrained without undue disruption of economic activity we cannot rely solely on monetary policies. For example, fiscal discipline is essential to ensure that excessive pressure is not placed on the financial and real resources of the economy. The structure of our tax system should be examined with an eye to the incentives it provides for productivity-expanding research and capital formation. And the full range of governmental policies should be reviewed to ensure that they do not add needlessly to costs and do not stunt innovation and competition.

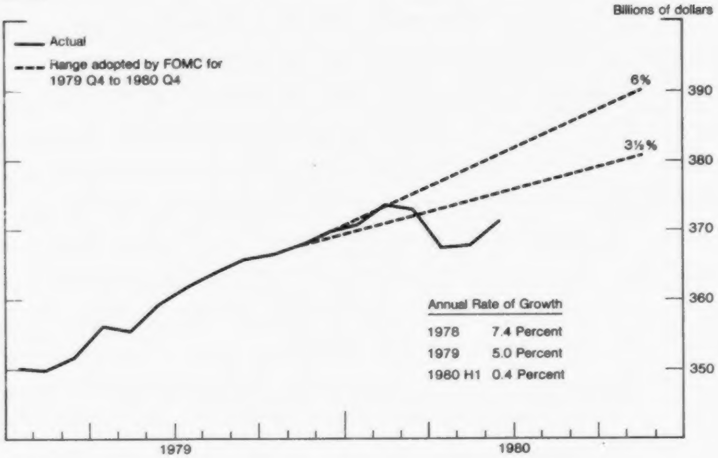
SECTION 3. MONEY AND CREDIT GROWTH IN 1980 AND 1981

In February the Federal Reserve reported to the Congress ranges of growth for the monetary aggregates in 1980 that it believed to be consistent with the continuing objective of reducing inflationary pressures over time while providing for sustainable growth in the nation's production of goods and services. These ranges anticipated a substantial deceleration in monetary growth in 1980 from the pace of the preceding year. Measured from the fourth quarter of 1979 to the fourth quarter of 1980, the ranges adopted were: for M-1A, 3-1/2 to 6 percent; for M-1B, 4 to 6-1/2 percent; for M-2, 6 to 9 percent; and for M-3, 6-1/2 to 9-1/2 percent. The associated range for bank credit expansion was 6 to 9 percent.

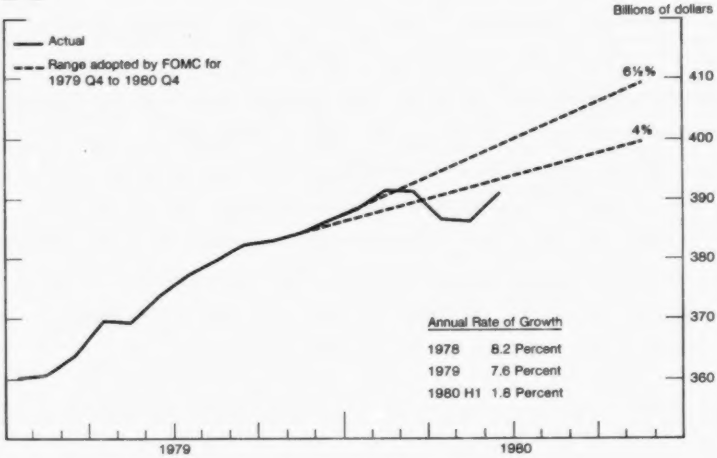
During the first half of 1980, growth of the monetary aggregates slowed considerably from the 1979 pace. The deceleration was particularly marked for the narrower aggregates, M-1A and M-1B, which grew at rates, below the lower limits of their longer-run ranges--at annual rates of about 1/2 and and 1-3/4 percent, respectively, from the fourth quarter of 1979 to the second quarter of 1980. (M-1A is currency and demand deposits held by the public, while M-1B includes checkable interest-bearing deposits as well.) At the same time, the broader aggregates, M-2 and M-3, grew at annual rates of 6-1/2 and 6-3/4 percent, respectively, which is somewhat above the lower limits of their ranges. In fact, by June, as the accompanying charts show, M-2--which includes money market fund shares and all deposits except large CDs at banks and thrift institutions--was around the midpoint of its longer-run range, and M-3 slightly below, while the narrower aggregates were moving back toward their ranges, following an unusually sharp drop in early spring.

Growth Ranges and Actual Monetary Growth

M-1A

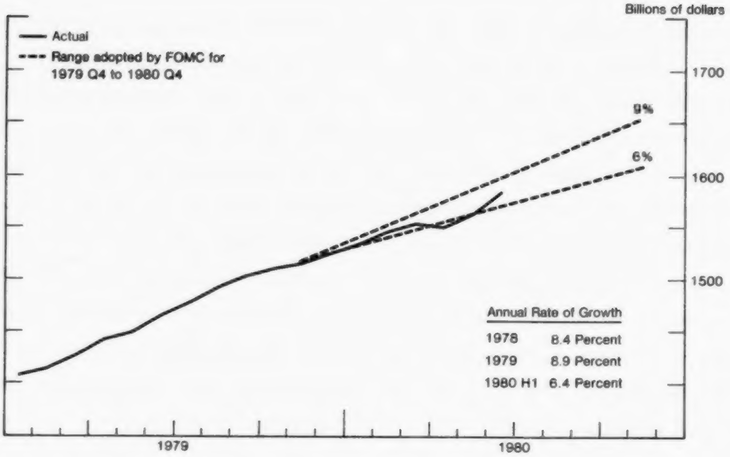


M-1B

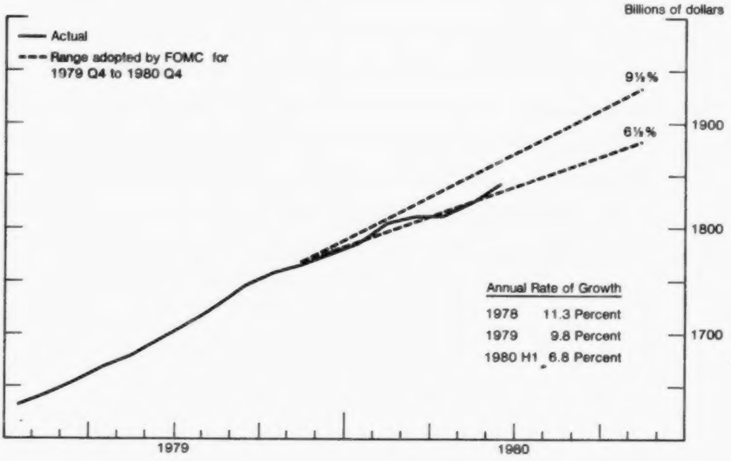


Growth Ranges and Actual Monetary Growth

M-2



M-3



The contraction in the narrower aggregates during the second quarter was much greater than would be expected on the basis of the historical relationships among money, income, and interest rates. This unusual weakness may have reflected exceptional efforts by the public to pare cash balances, such as have characterized some other periods following a sharp upward adjustment in market interest rates to new record levels. There may also have been an impact from the surge in debt repayments, especially at banks, after the imposition of the credit control program in mid-March, with some of the funds apparently coming out of cash balances. In light of these special circumstances affecting the public's demand for transactions balances, and given the relative strength of the broader aggregates and the usual lags between changes in credit conditions and growth in the narrow aggregates, the FOMC believed it appropriate to foster a more gradual return of M-1 growth to the ranges established earlier.

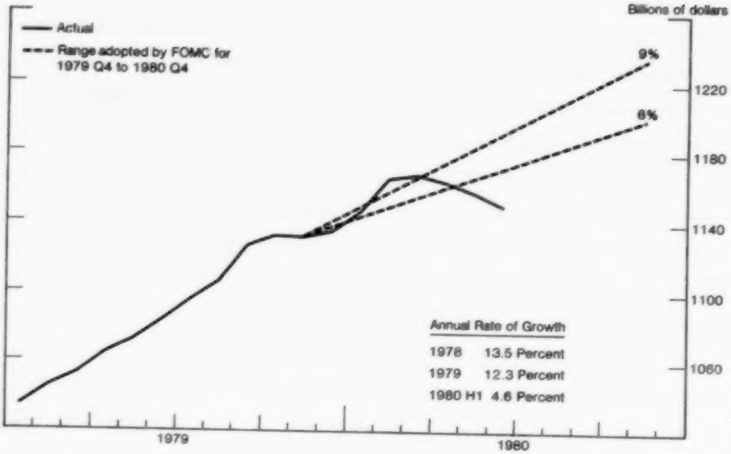
In connection with reserve targeting procedures, System open market operations supplied a large volume of nonborrowed reserves over the course of the second quarter. Given the weak demand for money and bank credit, most of the added nonborrowed reserves were used by banks to repay borrowings from the Federal Reserve discount window. Borrowings fell from a high of $2.8 billion on average in March to minimal levels recently, and the easing of bank reserve positions was reflected in a sharp decline in the federal funds rate. From their peaks of late March or early April, short-term interest rates have declined 7 to 9 percentage points and long-term rates by roughly 2 to 3 percentage points.

Expansion in the broader aggregates over the first half of the year reflected the very rapid growth for much of the time in money market mutual fund shares, 6 month money market certificates, and 2-1/2 year small saver certificates, instruments that pay market rates of interest. Late in the period, as short-term market interest rates declined sharply, the contraction in savings deposits at banks and other depository institutions halted, and the outstanding amount of those deposits began to rise. For part of the period, growth in M-3 was sustained also by continued issuance of large time deposits by commercial banks and thrift institutions, which are included in M-3 but not in M-2; however, large time deposits began to contract in late spring as credit demands weakened substantially.

Bank credit growth greatly exceeded the FOMC's range in the first quarter of the year. The second quarter, however, saw a sharp contraction in this measure, and credit growth was well below the FOMC-specified range as of midyear. Demands for bank loans by households and businesses dropped abruptly in the second quarter, while the banks--concerned about the possible erosion of profit margins by high cost funds obtained earlier and seeking to conform to the guidelines of the March 14 special credit restraint program--pursued relatively tight lending policies. Businesses, meanwhile, have met a substantial portion of their credit needs through issuance of commercial paper (which serves as a close substitute for bank credit for many large firms), by borrowing in bond markets, and by reducing holdings of liquid assets. Over the half year, the total of credit advanced by banks and in the private short-term money markets rose at an annual rate of around 7-1/2 percent.

Growth Ranges and Actual Bank Credit Growth

Bank Credit



At its meeting in July, the Federal Open Market Committee reassessed the ranges it had adopted for monetary growth in 1980 and formulated preliminary goals for 1981. The Committee elected to retain the previously established ranges for the aggregates over the remainder of 1980. This decision by the Committee took into consideration the recent behavior of the money stock measures as well as emerging economic conditions. In this regard it was recognized that, if the public continues to economize on cash balances to an unusual degree in the second half of the year, growth in the narrower aggregates would likely fall toward the lower end of the established ranges.

With respect to the broader aggregates, growth in the second half is likely to place them nearer the midpoints of their respective ranges, and in the case of M-2 quite possibly in the upper half of its range. Recent trends suggest that a continued substantial expansion in the interest-bearing nontransactions component of M-2 is likely. In the current cyclical environment, consumers have begun to reevaluate their financial positions and have reduced their borrowing and adjusted upward their rate of saving. Thus, if the recent lower level of interest rates persists, the outlook is for an augmented flow of funds to depository institutions along with continued, though slower, growth in money market mutual funds.

The Committee also noted that the recent sharp contraction in bank credit makes it quite likely that this measure will fall below the 6 to 9 percent growth range specified in February. A resumption of bank credit expansion during the second half is anticipated, but the strength of that move will depend to a considerable extent on patterns of corporate finance. The desire for balance sheet restructuring may well continue to mute business loan demands, although weaker corporate cash flows and a narrowing of the spread of the prime rate over commercial paper rates likely will prompt some borrowing at banks. Mortgage loan demands also should begin to recover as the year progresses, and the runoff in consumer loans is expected to abate.

One factor that contributed to the recent weakness in bank lending was the Board's special credit restraint program. As announced earlier, the program is being phased out this month because there is now no evident need for extraordinary measures to hold bank lending within reasonable bounds. In removing the special controls, the Board has emphasized its intention to continue to maintain aggregate growth in money and credit at rates consistent with a reduction in inflationary pressures.

With regard to monetary policy over the longer run, the FOMC reiterates its intent to seek reduced rates of monetary expansion over coming years, consistent with a return to price stability. While there is broad agreement in the Committee that it is appropriate to plan for some further progress in 1981 toward reduction of the targeted ranges, most members believe it would be premature at this time to set forth precise ranges for each monetary aggregate for next year, given the uncertainty of the economic outlook and institutional changes affecting the relationships among the aggregates. The extent and timing of adjustments in the targets will depend upon an appraisal of the outlook at the end of the year. The appropriate money growth in 1981 relative to 1980 of course will depend to some extent on the outcome in this year--that is, on exactly where in the present ranges the various aggregates fall at year-end.

In addition, the various measures of money will be affected in 1981 by shifts in the demand for different types of financial assets. The introduction of NOW accounts on a nationwide basis in January will accelerate the shift from regular demand deposits into interest-earning transactions balances, thereby depressing M-1A growth next year. On the other hand, M-1B probably will be boosted somewhat next year by shifts from savings deposits and other interest-bearing assets into NOW accounts. The range for M-1B thus may have to accommodate a period of abnormal growth as the public adjusts to the availability of a new instrument. The experience of the past year and a half with ATS accounts has indicated the difficulty of estimating in advance the public's demand for such balances. Although growth in M-2 and M-3 will not be affected by NOW account movements, these broader aggregates include other relatively new financial instruments, the demand for which is still subject to uncertainty. The behavior of these instruments in coming months will aid the FOMC in determining appropriate growth ranges for the broader aggregates in the 1981 period.

SECTION 4. THE ADMINISTRATION'S SHORT-TERM ECONOMIC GOALS AND THE RELATIONSHIP OF FEDERAL RESERVE OBJECTIVES TO THESE GOALS

The Administration, in association with its midyear budget review has updated its forecast of the behavior of major economic variables for 1980 and 1981. The revised figures are shown below.

The Administration's Forecast

	1980	1981
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	6-3/4	12-1/2
Real GNP	-3	2-1/2
Implicit price deflator	10	9-3/4
Average level in fourth quarter		
Unemployment rate (percent)	8-1/2	8-1/2

These estimates, which the Administration has indicated should be viewed as forecasts rather than as goals, show a considerably greater decline in real activity in 1980 than had been anticipated in the January Economic Report of the President. The outlook for nominal GNP growth through year-end has been lowered by a smaller amount, owing to a somewhat higher anticipated rate of inflation for the four quarters of 1980. The Administration's projections for this year fall within the ranges expected by the members of the FOMC.

The Administration has projected a resumption of output growth next year that places real GNP near the upper end of the range encompassed by the forecasts of the members of the FOMC. At the same time, the Administration's estimates place the rate of inflation somewhat above the range of the FOMC members' expectations. (Like the FOMC members' projections, the Administration's forecast does not include a tax cut provision for 1981.)

As indicated in the preceding section, the Federal Reserve intends to set monetary growth ranges for 1981 that will help to restrain inflationary pressures in the recovery period. As experience this year illustrates, considerable uncertainty attaches to any analysis of the relationships over relatively short periods among money, interest rates, and nominal GNP. However, a substantial expansion in demands for goods and services, accompanied by a lack of progress on the inflation front--or worse, an actual increase in inflation or inflationary expectations--would raise the possibility of a considerable firming of conditions in financial markets. Large and prolonged federal deficits would increase that risk. This highlights the urgency of concerted effort by the public and private sectors to reduce the rate of advance in costs and prices and the need to focus any discussions of fiscal action on approaches that would serve to alleviate cost pressures and bolster productivity.

CHAPTER 2

A REVIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

SECTION 1. ECONOMIC ACTIVITY DURING THE FIRST HALF OF 1980

Economic activity turned down early this year following almost five years of expansion. Between January and June, industrial production fell 7-1/2 percent, employment declined by about 1-1/4 million, and the unemployment rate jumped 1-1/2 percentage points. Real gross national product is estimated to have fallen at an annual rate of 9.1 percent in the second quarter, with the decline in activity widespread among major sectors of the economy. Retail sales have decreased substantially since January, housing starts have dropped to near-record postwar lows, and business outlays for equipment and new construction have declined. Although businesses were cautious in building inventories during the expansion, the severity of the recent decline in final sales has led to some involuntary stock accumulation; as in past cycles, the resulting efforts to curb inventory growth have played a significant role in the weakening of orders and production.

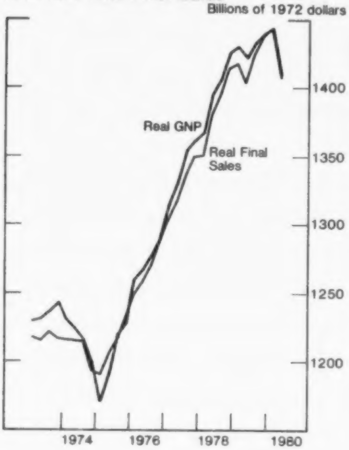
Recent reductions in aggregate demand, coupled with a slower rise of energy prices, meanwhile have brought some moderation in the overall pace of inflation. The producer and consumer price indexes have risen at much less rapid rates in the past few months than they did earlier in the year. Moreover, there are indications from consumer surveys that inflationary expectations have been lowered. Nevertheless, inflation still possesses a strong momentum, with unit labor costs continuing on a steep upward trend.

Personal Consumption Expenditures

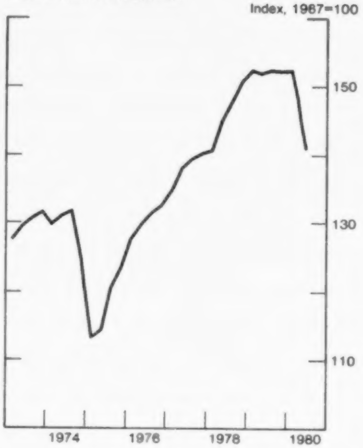
Personal consumption expenditures fell sharply in real terms during the first half. A number of adverse trends had characterized household finances for some time prior to the beginning of 1980. Real disposable income had stagnated after 1978, household liquidity positions had weakened as liabilities

Current Indicators of Economic Activity

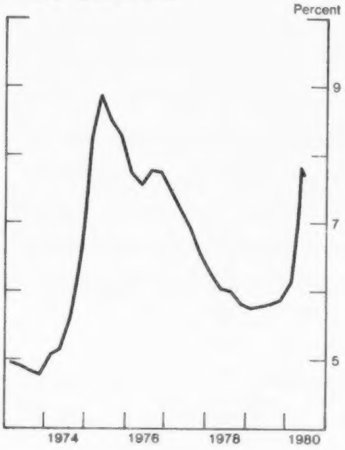
Real GNP and Final Sales



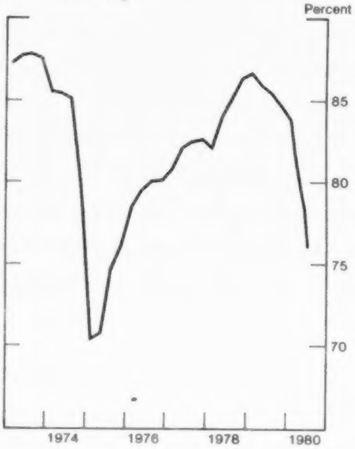
Industrial Production



Unemployment Rate



Capacity Utilization in Manufacturing

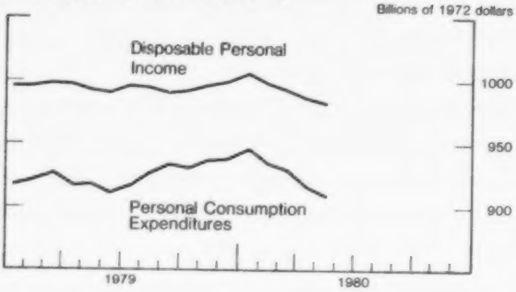


increased faster than financial assets after late 1976, and a near-record proportion of disposable income had been committed to the servicing of debt. Moreover, consumer confidence, as measured by opinion surveys, had deteriorated to levels last seen in the 1973-75 recession. In the light of these trends, a downward adjustment of consumer outlays might have been expected last year; the fact that it did not occur appears attributable in part to growing expectations of inflation that fostered a buy-in-advance psychology.

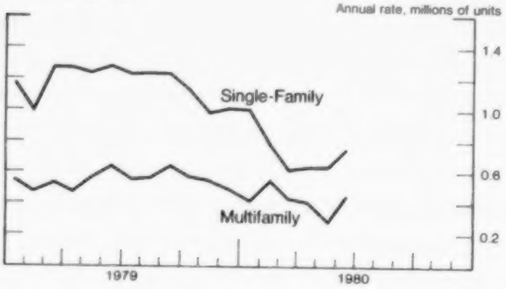
Between January and May, retail sales fell 6-1/2 percent in nominal terms and more than 9-1/2 percent in real terms—the sharpest four-month drop in the postwar period. Preliminary estimates for June, however, indicate that sales moved up somewhat. As in past recessions, large decreases in sales this year have occurred for the relatively discretionary items of consumer expenditure. Automobile sales in June averaged only 7.6 million units at an annual rate, close to the May pace, which was the slowest since late 1974. Furniture and appliance sales also are down sharply this year, in part because of the fall in housing sales. But weakness in consumer outlays has not been confined to the durable goods sector. Purchases of nondurables in real terms also have been falling since late last year, with sizable declines recorded for clothing and general merchandise.

Since January, real disposable income has decreased substantially as employment and hours worked have fallen and prices have continued upward at a rapid pace; nonetheless, the retrenchment by consumers has lifted the saving rate somewhat above the extraordinarily low level of the fourth quarter of last year. It still remains low by historical standards, however, and uncertainty

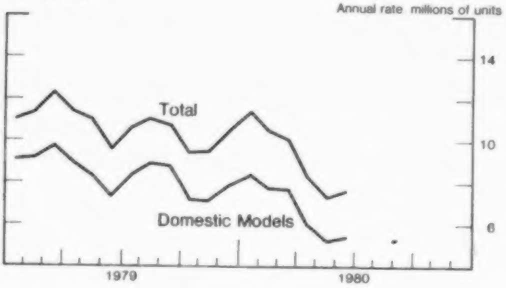
Real Personal Consumption Expenditures and Real Disposable Personal Income



Housing Starts



Auto Sales



about job and income prospects may well prompt households to enlarge precautionary savings, thereby contributing further to the weakness in personal consumption expenditures.

Residential Construction

Homebuilding activity has experienced a severe decline. Housing starts, which averaged nearly 1-3/4 million units at an annual rate during the first nine months of 1979, began to fall sharply last autumn. By December, starts were at a 1-1/2 million unit pace, and by May they had declined almost to a 900,000 rate. June saw a pickup in starts to a 1-1/4 million annual rate.

In the single-family sector, starts dropped 45 percent between the third quarter of 1979 and the second quarter of this year. Although demographic factors remained quite favorable during this period, the demand for such dwellings was curtailed by the increased cost of homeownership associated with higher house prices and the rapid rise in mortgage interest rates. The monthly cost of interest and principal on an average-priced new home financed with a conventional mortgage rose to $700 in May--a third higher than six months earlier and 50 percent above the same month of 1979. Households probably were increasingly reluctant to undertake such heavy financial obligations, especially as income and employment conditions weakened this year.

Home sales have dropped almost 40 percent from the pace of last summer. Although production adjustments have reduced the number of unsold new single-family dwellings on the market, these unsold units bulk larger relative to the recent slower rate of sales. At the May sales pace, which was up sharply from April, there was almost a nine-month supply of unsold new single-family units on the market. The pickup in sales in May is perhaps a sign of some increased interest on the part of homebuyers, prompted by the recent easing in financial markets; however, the still large overhang of unsold homes is likely to discourage a quick resumption of building in many localities.

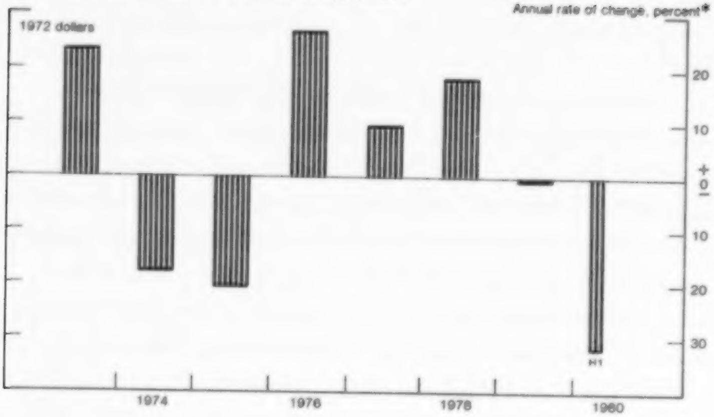
Multifamily housing starts began declining sharply late last year and in the second quarter were off about 35 percent from the already-reduced pace of the third quarter of 1979. The decline in this sector has been less severe than in the 1973-75 period, as low vacancy rates in many areas and an acceleration in rent increases beginning in late 1979 have given builders an incentive to sustain a significant level of apartment construction in the face of high construction costs and tight financial conditions. In addition, demands for condominiums--a lower-cost alternative to single-family homeownership--have provided support to multiunit activity.

Business Spending

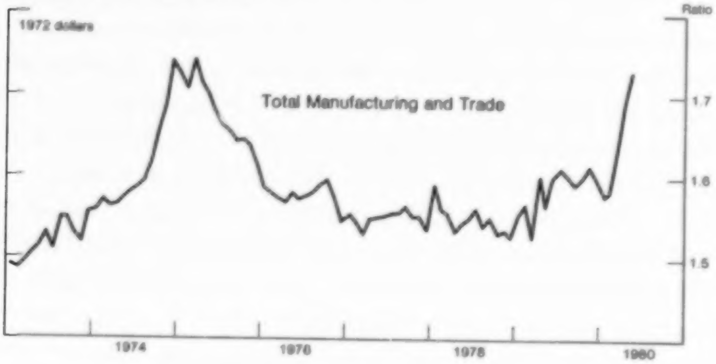
Business spending on plant and equipment has slowed in recent months as firms have sought to avoid expanding capacity at the onset of a recession. Spending on nonresidential structures, which accounted for much of the gain in investment during 1979, peaked in January and declined substantially in the following months. Business purchases of trucks and automobiles also have been falling since early this year, as have outlays for other capital equipment.

Weakness in capital spending in the first half of the year--as well as in forward-looking indicators of investment activity such as surveys, construction contracts, and equipment orders--probably reflected businessmen's anticipations that sales may remain sluggish for a while. In addition, corporate cash flows are diminishing, and with liquidity positions already

Contracts and Orders for Plant and Equipment



Inventories Relative to Sales



*Annual changes are from Q4 to Q4; semi-annual change is from Q4 to the April-May average.

strained in many instances, there may be a reluctance to undertake additional projects requiring external financing. Although interest rates have fallen dramatically from the high levels reached earlier this year, growing excess plant capacity suggests the likelihood of further decreases in real outlays, while firms take advantage of lower long-term rates to restructure their balance sheets.

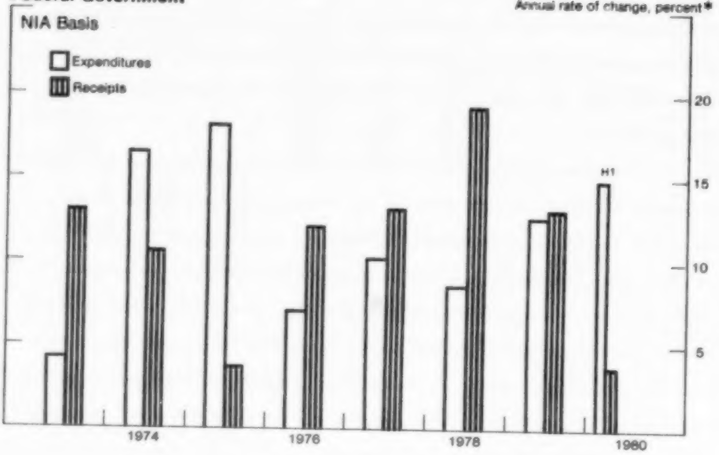
Despite sizable cutbacks in production, some involuntary inventory accumulation appears to have occurred this spring as a consequence of the steep fall in sales. The stock-sales ratio for all manufacturing and trade in real terms rose only moderately during the first quarter, but climbed appreciably in April and May to near the level of late 1974. Since the start of the year, substantial increases in the ratio have been registered in most major industries with especially large rises for primary metals manufacturers, furniture and appliance retailers, and the motor vehicle industry. Auto sales incentive programs and production adjustments in the first quarter of 1980 largely eliminated excessive stocks that had resulted from last summer's gasoline shortages. However, beginning in mid-April, automobile sales plummeted and, despite further curtailments of production, some overhang of stocks at dealers reappeared.

Government

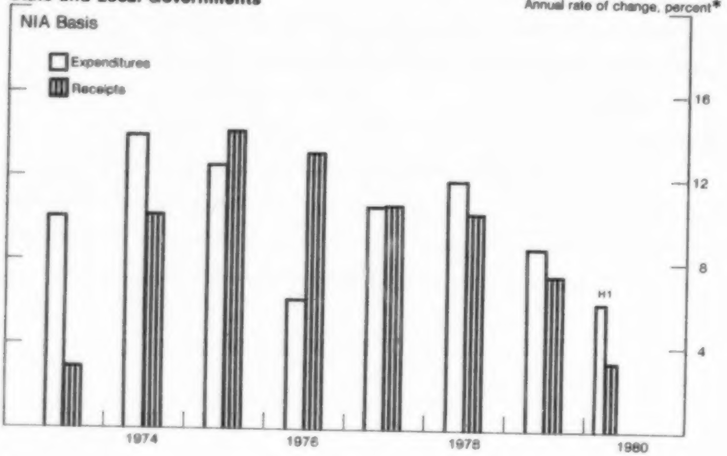
Spending at all levels of government has been restrained in recent months. Total federal expenditures, which grew rapidly in the early months of the year, moderated in the second quarter largely as a result of the March budget cuts. Growth in receipts fell off much more, however, as weakness in

Public Sector Expenditures and Receipts

Federal Government



State and Local Governments



*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

Data for 1980 H1 are partially estimated by the Federal Reserve.

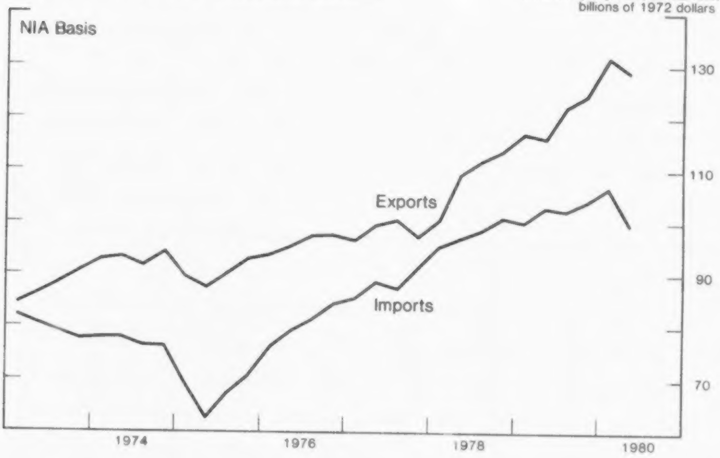
personal income and profits offset the impact of additional revenue from the windfall profits tax on oil producers. As a result, the federal deficit on a national income accounts basis probably deepened by about $30 billion, at an annual rate, between the fourth quarter of 1979 and the second quarter of 1980. However, the high-employment budget, a better indicator of the thrust of discretionary fiscal policy, showed a movement toward restraint during this period.

State and local government spending fell in real terms during the first half of 1980, as governmental units curtailed outlays in response to the slower growth of revenues caused by tax cuts enacted in 1979, the weakening economy, and the March reductions of federal grants-in-aid. The reduced pace of spending was most pronounced for construction activity because federal funding was cut back and municipal bond issuance was constrained in the first quarter by high interest rates. Despite the downward adjustments of outlays, the aggregate operating deficit of the state and local government sector apparently widened considerably in the spring.

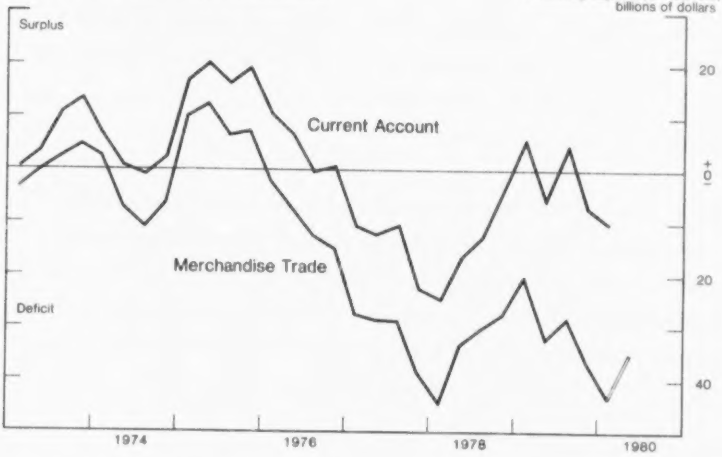
International Trade and Payments

Real exports of goods and services continued to grow rapidly in the first quarter of 1980, but the rise appears to have slowed somewhat in the second quarter. The deceleration largely reflected the slowing of economic expansion abroad and the fading of the impact of the 1977-78 real depreciation of the dollar. All of the growth in the first half was concentrated in nonagricultural exports; agricultural shipments were reduced, partly because of the

Exports and Imports of Goods and Services



Trade and Current Account Balances



Data for 1980 Q2 Merchandise Trade Balance are partially estimated embargo on additional grain sales to the Soviet Union imposed by the President in January.

The volume of imports, meanwhile, began to fall off as U.S. economic activity slackened and as higher prices and greater fuel efficiency acted to restrain oil imports. The volume of non-oil imports rose slightly on balance in the first half of 1980, but all of the increase was in the first quarter. The quantity of oil imports fell, apparently reaching its lowest rate in four years in the second quarter. Despite a declining volume of oil imports in the first quarter, higher OPEC prices resulted in a continuation of the rapid growth in the dollar value of oil imports. The oil import bill nearly doubled between the fourth quarter of 1978 and the first quarter of 1980; in the second quarter the value of oil imports changed little as lower volume offset a further rise in import prices.

The U.S. merchandise trade deficit increased about $6-1/2 billion, at an annual rate, in the first quarter of this year from the rate in the last quarter of 1979. The current account moved from a deficit of about $7 billion at an annual rate in the fourth quarter, and near balance for the year 1979, to a deficit of about $10 billion in the first quarter of 1980. Higher foreign earnings of U.S. oil companies offset part of the rise in the merchandise trade deficit. Partial data indicate that the trade and current-account deficits narrowed in the second quarter.

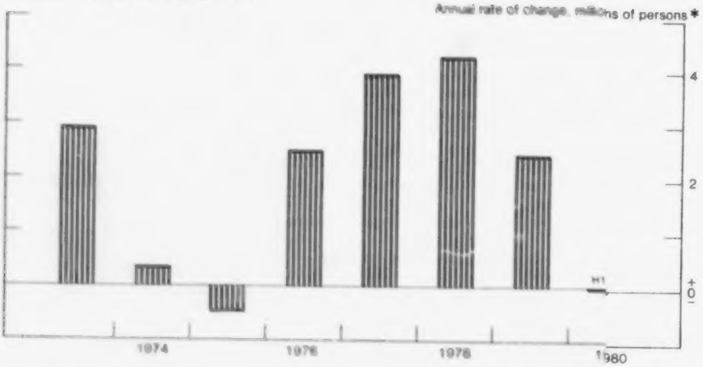
SECTION 2. LABOR MARKETS AND CAPACITY UTILIZATION

Labor demand was relatively well-maintained early in the year, but it fell off steeply in the spring as firms responded to the sharp declines in sales by cutting their work forces and shortening workweeks. Between January and June, the number of workers on the payrolls of nonfarm establishments fell almost 950,000; total employment, as measured by the household survey, fell more than 1-1/4 million. With layoffs rising, the nation's jobless rate jumped from 6-1/4 percent in January to 7-3/4 percent in May and June.

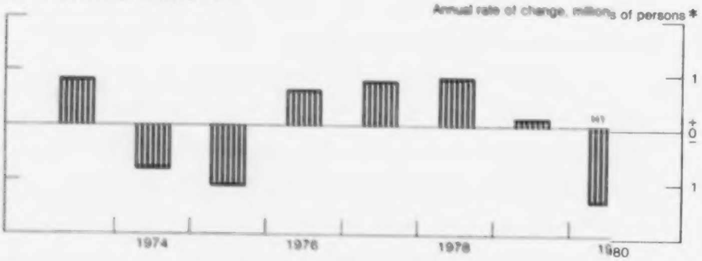
Much of the cutback in employment occurred in the construction sector and in durable goods manufacturing, especially motor vehicle and related industries. By June, the number of auto workers on indefinite layoff was nearly 250,000 (about 30 percent of total hourly workers in the industry), and substantial layoffs had occurred in the steel and tire industries as well. Construction employment began to drop early in the year, and subsequently suppliers of building materials also reduced their payrolls. During the spring, however, weakness in labor demand began to spread throughout the economy; employment at trade establishments dropped 190,000 over the second quarter, and in June payrolls in the service-producing sector registered the first monthly decline since 1975.

In addition to trimming payrolls, employers have curtailed work schedules in light of the weakening of sales. Since January, the average workweek at manufacturing establishments has been shortened almost 1-1/4 hours. More generally, the number of workers on part-time schedules for

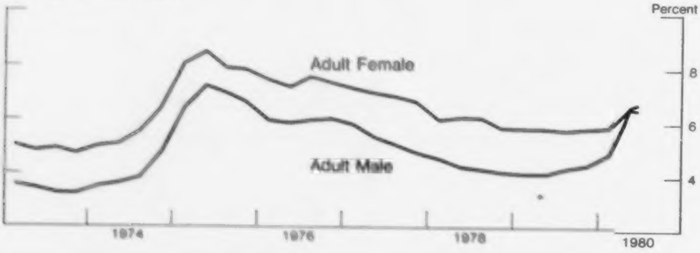
Nonfarm Payroll Employment



Manufacturing Employment



Unemployment Rates



*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2 economic reasons rose sharply in the second quarter, with former full-time jobholders accounting for most of the increase.

The rise in joblessness has been widespread among demographic and occupational groups, with especially large increases reported among adult males. Since December, the jobless rate among men has climbed almost 2-1/2 percentage points, compared with an increase of 3/4 percentage point for adult women, and June marked the first time in two decades that the rate for men was higher than that for women. Unemployment among blue-collar workers rose sharply to an 11-1/2 percent rate in June, the highest since September 1975. In contrast, unemployment rates among white-collar workers have increased only marginally since the end of 1979.

The adjustments in output by firms, especially in the second quarter, were reflected in a sharp decline in the index of industrial production. Between January and June, industrial production fell nearly 7-1/2 percent. Production declines in auto-related industries and in industries supplying construction materials began early in the year, but by late spring cutbacks were occurring in most other industries as well. Among manufacturing firms, capacity utilization in June dropped to 76 percent, almost 11 percentage points below its 1979 peak.

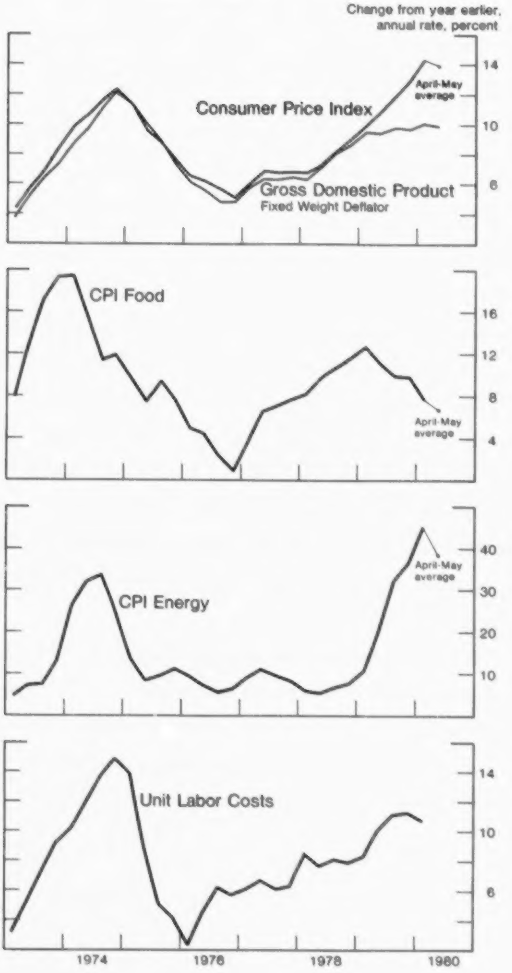
SECTION 3. PRICES, WAGES AND PRODUCTIVITY

After exploding upward in the early months of the year, rates of price increase moderated significantly in the second quarter. The improvement resulted primarily from a stabilizing of energy prices and from declines in the prices of nonferrous metals, after a flurry of speculative activity earlier in the year. Increases in the prices of construction materials and components also slowed noticeably in the second quarter with the decline in activity in the housing sector.

In the energy area, retail prices surged in January and February, in large part the result of the hike in OPEC prices that occurred in late 1979, but the pace of increase then slowed noticeably in the spring, as inventories reached near-record levels and demand continued to drop. The increase in energy prices also moderated at the producer level. Nonetheless, indirect effects of earlier increases in the prices of fuels and petroleum feedstocks were still evident through the end of June in items such as plastics and rubber products, industrial chemicals, and household supplies. Moreover, a number of factors—including the latest increases in OPEC prices, the curtailment of gasoline production, and the progressive decontrol of crude oil prices—suggest that further relief in the energy area is not to be expected.

Food prices generally have exerted a moderating influence on aggregate price measures since the beginning of the year. At the producer level, finished food prices fell at about a 4-1/2 percent annual rate between December and June. Steep drops in wholesale prices through May—particularly for livestock—alleviated cost pressures at the retail level, contributing to relatively

Prices and Labor Costs



stable retail food prices since the end of last year. However, recent developments in the markets for livestock and fresh produce indicate that food prices also are likely to rise more rapidly in the second half of the year.

Inflationary pressures have persisted in sectors outside food and energy since the beginning of the year. In the consumer price index, increases in the homeownership component have been particularly large, as the measures of mortgage rates and home purchase prices both advanced rapidly in the first half of this year; the recent easing of mortgage rates will likely hold down increases in the CPI during the next few months. In the producer price index, prices of capital equipment accelerated in the first half of 1980 from the already rapid pace of 1979.

Labor cost pressures remained intense in the first half of 1980, as compensation increases were substantial while productivity declined further. Output per hour in the private nonfarm business sector dropped at about a 1-1/2 percent annual rate in the first quarter, after falling 2 percent over the preceding year. At the same time, hourly compensation accelerated to a 10-1/4 percent annual rate, so that the unit labor costs of nonfarm businesses rose at about an 11-3/4 percent rate in the first quarter. Preliminary data for the second quarter suggest that unit labor costs continued to rise rapidly, as productivity contracted further. Although cyclical reductions in overtime and the changing employment mix may restrain the growth in total compensation somewhat in coming months, wage demands are likely to remain strong, especially in light of past increases in consumer prices. Thus, upward pressures on unit labor costs will probably remain substantial over the near term.

SECTION 4. FINANCIAL DEVELOPMENTS DURING THE FIRST HALF OF 1980

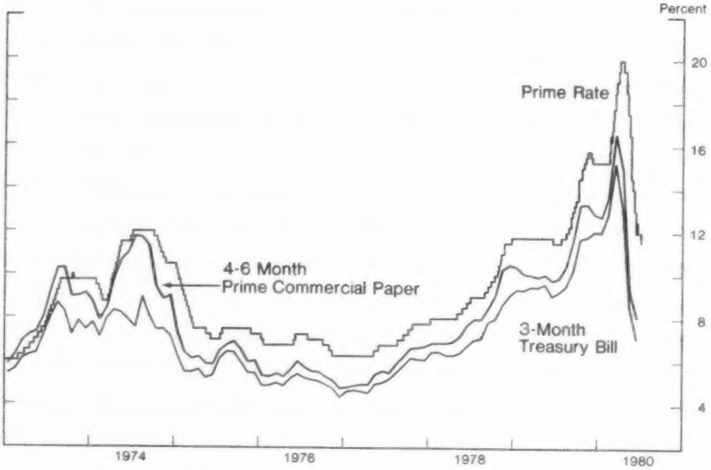
Interest Rates

Market rates of interest moved sharply higher in the early months of 1980, exceeding previous record levels and peaking around the end of the first quarter. These increases were largely reversed in the second quarter amid a substantial downslide in economic activity and contracting demands for money and credit. The upward pressure on yields at the turn of the year resulted from a combination of factors, including a deterioration in inflationary expectations as actual price increases accelerated in January and February, the failure of incoming data to confirm the long-anticipated downturn in activity, and international political developments that raised the likelihood of an increase in federal deficit spending. In February, moreover, growth in money and credit surged, creating demands for bank reserves well in excess of the provision of nonborrowed reserves consistent with the Federal Reserve's target ranges for growth in the monetary aggregates. In the Treasury bill market, in particular, the resulting rise in short-term interest rates was reinforced by large sales of securities by foreign institutions to finance intervention in foreign exchange markets.

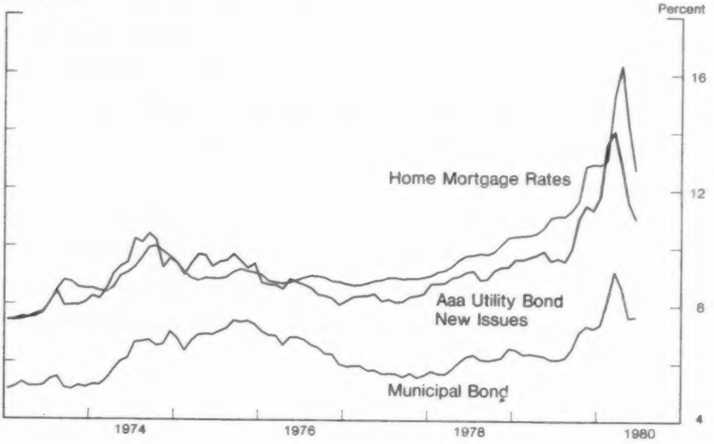
On March 14, the Board of Governors took actions of a temporary nature designed to reinforce the effectiveness of the measures announced in October 1979 and thus to provide greater assurance that the monetary goals reported to the Congress in February would be met. These actions, some of which were taken under the authority of the Credit Control Act as part of a broad government effort aimed at reducing inflationary pressures, included:

Interest Rates

Short-term



Long-term



(1) a special credit restraint program directed toward limiting the growth in loans to U.S. customers by commercial banks and finance companies to ranges consistent with the monetary and credit objectives of the Federal Reserve; (2) a special deposit requirement for all types of lenders on increases in certain categories of consumer credit; (3) an increase in the marginal reserve requirement on managed liabilities of large member banks and U.S. branches and agencies of large foreign banks; (4) a special deposit requirement on increases in managed liabilities of large nonmember banks; (5) a special deposit requirement on increases in total assets of money market mutual funds; (6) a surcharge of 3 percentage points on frequent borrowing by large member banks from Federal Reserve Banks.

These measures hastened the movement toward reduced credit availability already in train at many lenders, and apparently increased the resolve of consumers to curtail their use of credit. In subsequent weeks, incoming data revealed a substantial slackening in money and credit growth to well within the Federal Reserve's objectives. In light of these developments, the Board amended the special credit program: on May 6 the 3 percentage point surcharge on discount borrowing by large banks was eliminated, and on May 22 special deposit requirements were reduced by half and the special credit restraint guidelines were modified. On July 3 the final phase-out of the program was announced.

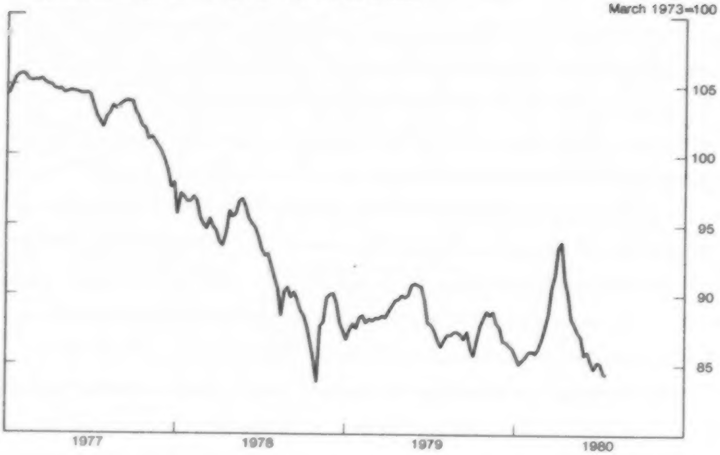
The rise in most interest rates came to a halt in late March and early April, and yields began to move down as demands for money and credit dropped abruptly in response to developing slack in the economy. Most private short-term rates fell 7 to 9 percentage points, to their lowest levels since the spring of 1978. In long-term securities markets, bond yields retraced most or all of the increases recorded earlier in the year, as market participants appear to have lowered their expectations of inflation. The restraining posture of monetary and fiscal policy, as well as moderating rates of price increase in the cyclical downturn, has contributed to this improved outlook for price changes.

Foreign Exchange Markets and the Dollar

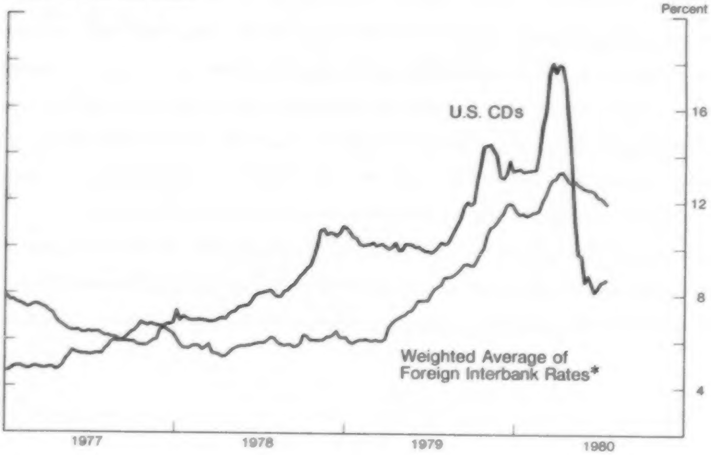
Movements in U.S. interest rates greatly influenced fluctuations in the foreign exchange value of the dollar over the first half of 1980. The dollar was in strong demand early in the year when U.S. interest rates rose sharply. The growing perception by market participants of accelerating inflation and worsening payments deficits abroad gave added impetus to the dollar's rise over this period, as did the announcement of credit control measures on March 14. Authorities in a number of foreign countries also moved to tighten monetary conditions, but the resulting increase in foreign interest rates lagged well behind that of U.S. rates. The strengthening in the foreign exchange value of the dollar in February and March was moderated somewhat by substantial intervention activities by U.S. and foreign monetary authorities.

The peaking and subsequent steep decline in U.S. interest rates in early April triggered heavy selling pressure on the dollar in international markets, and its foreign exchange value fell in the April to June period. Foreign and U.S. monetary authorities intervened to moderate this decline by making net purchases of dollars. Even so, by the end of June earlier gains were entirely erased, and the weighted-average exchange value of the dollar at mid-year was little changed from its value at the beginning of the year.

Weighted Average Exchange Value of U.S. Dollar*



3-Month Interest Rates



* Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries

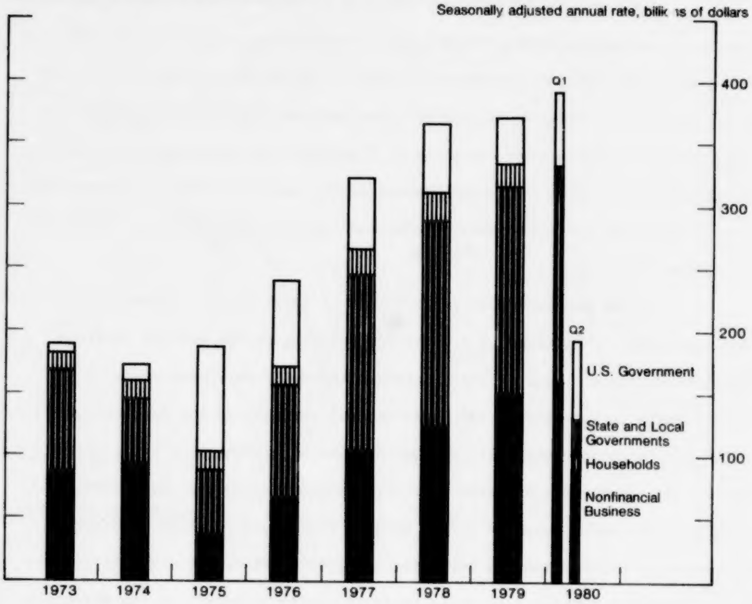
Domestic Credit Flows

Net funds raised in credit markets by domestic nonfinancial sectors of the U.S. economy totaled a sizable $391 billion at an annual rate in the first quarter of 1980, but contracted sharply to an estimated $193 billion in the second period. This exceptionally large decline in borrowing reflected in large part the recent sudden weakening in production and sales activity; in addition, monetary restraint, supplemented by the special policy actions of mid-March, contributed to tauter credit terms and reduced availability of funds at many lenders.

In the private sector, the volume of funds raised in the first quarter was greatly enlarged by a surge in borrowing on the part of nonfinancial business firms. Some of this increased borrowing reflected needs to finance growth in inventories and fixed capital outlays, as the gap between such expenditures and internally generated funds of nonfinancial corporations widened. But fears that unchecked inflation would lead to the imposition of credit controls and a consequent reduction in credit availability apparently led to a burst of anticipatory borrowing by firms as well. As a result, corporations added substantially to their holdings of liquid assets in the first quarter and appear to have drawn down these holdings in subsequent months.

As interest rates moved up rapidly early in the year, businesses concentrated their credit demands in short- and intermediate-term markets, with borrowing at banks and in the commercial paper markets especially heavy. Corporate bond financing remained relatively low as businesses, especially industrial firms, were reluctant to issue long-term debt at historically high

**Net Funds Raised in Credit Markets
By Domestic Nonfinancial Sectors**



Source: Federal Reserve Board *Flow of Funds Accounts*. Data for 1980 Q2 are partially estimated.

yields. This pattern of corporate financing shifted dramatically, however, when interest rates dropped rapidly in the spring. Public offerings of longer-term corporate bonds accelerated to unprecedented levels, with the proceeds from many of these issues being used to pay down bank debt.

After March, commercial banks--concerned both about pressures on their earnings margins as interest rates dropped and about meeting the loan growth guidelines of the voluntary special credit restraint program--tended to discourage business borrowers. In particular, adjustments in the bank prime lending rate lagged substantially behind downward movements in other market rates, greatly increasing the relative cost of this source of financing. As a result of the relatively high cost of bank credit, coupled with a desire of businesses to adjust their balance sheets following the heavy reliance on short-term debt in previous months, business loans at banks contracted markedly in the second quarter. Although commercial paper issuance by firms remained very large, total short- and intermediate-term business credit demands in the second quarter moderated appreciably from the first-quarter pace. Late in the second quarter, the prime rate began to move down, narrowing the gap with market rates somewhat; survey data, furthermore, suggest that banks in May were making a large share of short-term business loans at below-prime interest rates.

In the household sector, consumers greatly reduced their use of installment credit during the first half. The large growth of consumer installment and mortgage debt in 1979--both in absolute terms and in relation to disposable income--had produced a marked deterioration in household liquidity. The combination of resulting heavy debt burdens, high interest rates, and, in some states, restrictive usury ceilings acted to slow growth of installment credit in late 1979 and the first quarter of 1980. The volume of outstanding installment credit contracted in the second quarter as consumers curtailed expenditures and repaid debt against a backdrop of rapidly declining real incomes and rising unemployment. Credit-tightening measures by lenders after the announcement of the credit-control package on March 14 and uncertainty on the part of consumers about the effects of those controls contributed further to the reduction in credit use.

Household borrowing in mortgage markets also slowed considerably in the first half. Reduced deposit flows and pressures on earnings margins from rising costs of funds constrained the lending activity of thrift institutions and pushed mortgage rates to record levels in March. Many would-be homebuyers were deterred by the high cost of mortgage credit. More recently, lower market interest rates have helped to reduce cost pressures for thrift institutions and have contributed to a pickup in deposit flows. Sharp drops in mortgage rates since early April and reports of some easing in nonrate terms suggest that lending institutions have become more active in seeking mortgage loans since early June. But mortgage rates remain high by historical standards, while demands for housing and housing credit continue to be damped by a weak economy and by the liquidity concerns of households; consequently, mortgage commitment activity apparently has remained relatively sluggish.

The Treasury borrowed heavily in credit markets in the first half to finance the combined deficits of the federal government and off-budget agencies. Normal seasonal patterns in federal cash flows associated with the timing of tax receipts led to a concentration of the Treasury's borrowing in the first three months of the year. Although the first-quarter deficit was further deepened this year by unusually large tax refunds associated with over-withholding in 1979, the Treasury was able to even out its borrowing pattern somewhat by permitting its cash balance to drop over the first quarter and then rebuilding it in the second.

In contrast to the federal sector, net borrowing by state and local governments dropped off in the first quarter but accelerated appreciably in the second. Many municipal governments postponed or canceled scheduled bond issues early in the year because of high interest rates; for some governmental units, these actions were necessitated by the rise of interest rates above statutory limitations. But the volume of tax-exempt financing picked up considerably in the second quarter when interest rates fell and many previously postponed bond issues were brought to market. The financing needs of state and local units generally increased over the first half in response to slower growth of revenues and a consequent widening of their operating deficits. In addition, the volume of tax-exempt securities issued continued to be boosted by offerings of mortgage revenue bonds, designed to finance single-family housing.

NG VOLUNTARY LEADERSHIP IN A CHANGING WORLD

JUL 28 1980

Chamber of Commerce of the United States
HILTON DAVIS, VICE PRESIDENT
LEGISLATIVE AND POLITICAL AFFAIRS
202-659-6140
1615 H STREET, N.W.
WASHINGTON, D.C. 20062

July 28, 1980

The Honorable Ernest F. Hollings
Chairman
Committee on the Budget
United States Senate
Washington, D. C. 20510

JUL 28 [illegible]

Dear Mr. Chairman:

Attached is a statement expressing the views and recommendations of the Chamber of Commerce of the United States on the Second Concurrent Resolution on the Budget -- Fiscal 1981.

We will appreciate your consideration of these views and request that the statement be made a part of the record.

Cordially,

Hilton Davis

Hilton Davis, Vice President
Legislative and Political Affairs

Attachment

cc: Committee Members
John T. McEvoy
Robert Boyd

ERNEST F. HOLLINGS, S.C., CHAIRMAN
WARREN G. MAGNUSON, WASH.
LAWTON CHILES, FLA.
JOSEPH R. BIDEN, JR., DEL.
J. BENNETT JOHNSTON, LA.
JIM SASSER, TENN.
GARY HART, COLO.
HOWARD M. METZENBAUM, OHIO
DONALD W. RIEGLE, JR., MICH.
DANIEL PATRICK MOYNIHAN, N.Y.
J. JAMES EXON, NEBR.
GEORGE J. MITCHELL, MAINE
HENRY BELLMON, OKLA.
PETE V. DOMENICI, N. MEX.
BOB PACKWOOD, OREG.
WILLIAM L. ARMSTRONG, COLO.
NANCY LANDON KASSEBAUM, KANS.
RUDY BOSCHWITZ, MINN.
ORRIN G. HATCH, UTAH
LARRY PRESSLER, S. DAK.
JOHN T. MC EVOY, STAFF DIRECTOR
ROBERT S. BOYD, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON THE BUDGET
WASHINGTON, D.C. 20510

July 21, 1980

Mr. Hilton Davis
Legislative Action Vice President
Chamber of Commerce of the
United States
1615 H Street, N.W.
Washington, DC 20062

Dear Mr. Davis:

Thank you for your letter requesting the opportunity for a witness from the U.S. Chamber of Commerce to testify during our hearings on the Second Concurrent Resolution on the FY 1981 Budget.

Unfortunately, we have very limited time available for these hearings, and have already fully scheduled them with appearances from Administration witnesses, the Director of the Congressional Budget Office, the Chairman of the Board of Governors of the Federal Reserve System, and five non-government economists representing a wide spectrum of views. We would, however, be pleased to have the benefit of your views for distribution to Members of the Committee and inclusion in the record of our hearings. I would welcome receiving a written statement from you concerning the appropriate budget policy for the current difficult circumstances.

I share the Chamber's view of the paramount importance of Federal budget policy and appreciate your past support of, and continuing interest in, the Congressional Budget Process.

Sincerely,

Ernest F. Hollings

JUL 02 1980

Susan

Chamber of Commerce of the United States
LEGISLATIVE ACTION VICE PRESIDENT
HILTON DAVIS
202 · 659-6140
1615 H STREET, N.W.
WASHINGTON, D.C. 20062

June 27, 1980

The Honorable Ernest F. Hollings
United States Senate
Washington, D. C. 20510

JUL 2 1980

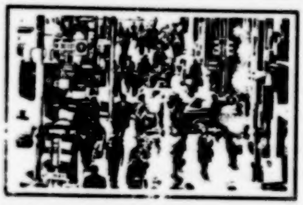
Dear Senator Hollings:

The Chamber of Commerce of the United States respectfully requests the opportunity to testify before the Senate Budget Committee, during hearings on the Second Concurrent Resolution on the budget on July 22 - 24. The U. S. Chamber considers the issue of the Federal budget to be of paramount importance, and we will welcome the occasion to present our views. The witness for the U. S. Chamber will in all likelihood be Dr. Richard Rahn, Vice President and Chief Economist.

Cordially,

Hilton Davis

Hilton Davis



Statement of the

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

ON: SECOND CONCURRENT RESOLUTION
ON THE BUDGET -- FISCAL
YEAR 1981

TO: SENATE COMMITTEE ON THE BUDGET

BY: RICHARD W. RAHN

DATE: JULY 28, 1980

STATEMENT
on the
SECOND CONCURRENT RESOLUTION ON THE BUDGET--FISCAL YEAR 1981
for submission to
SENATE COMMITTEE ON THE BUDGET
for the
Chamber of Commerce of the United States
by
Dr. Richard W. Rahn*
July 28, 1980

On behalf of its 97,000 members, the Chamber of Commerce of the United States welcomes the opportunity to comment on the Second Concurrent Resolution on the federal budget for fiscal 1981.

SUMMARY

The U.S. Chamber recommends that in recognition of the current recession and the present reality of declining productivity, declining or stagnant real personal incomes, record low personal savings rates, falling capital stock per worker, and a stubbornly high rate of inflation, Congress should:

- Make room in the Second Concurrent Budget Resolution for prompt enactment of a $25 to $35 billion tax reduction, of which one-half should promote capital formation.
- Complete the reconciliation process begun under the First Concurrent Resolution, and make further spending reductions as part of the Second Resolution.
- Enact a strict spending limitation to reduce successively the federal share of gross national product in 1981 and later years.
- Strengthen the credibility of the budget process and concentrate on balancing the budget over the course of the business cycle, rather than relying on unrealistic economic assumptions and crippling tax increases to create the illusion of a balanced budget in 1981.

PROFILE OF THE CURRENT RECESSION

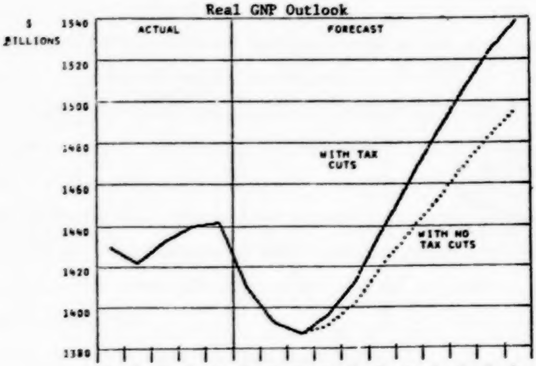
Although there are some indications that the rate of decline in real gross national product may be moderating, the outlook for the nation's economy is still quite pessimistic. The U.S. Chamber forecasts a year-over-year decline of 1.6% in real economic activity in 1980. The recession is expected to continue throughout 1980, and result in a 3.8% peak-to-trough decline in real GNP (compared to a 5.7% decline during the 1974-75 recession). The outlook for 1981 assumes implementation of a tax cut. No such relief has been included in the Office of Management and Budget Mid-Session Review issued on July 21. In the absence of any such stimulus to work, save and invest, we can expect very slow growth in economic activity between 1980 and 1981. Even with the $27 billion tax reduction assumed by the U.S. Chamber's forecast, the recovery in 1981 will be anemic, averaging 1.3% for the year as a whole.

---

*Vice President and Chief Economist of the Chamber of Commerce of the United States

Chart I

Real GNP Outlook



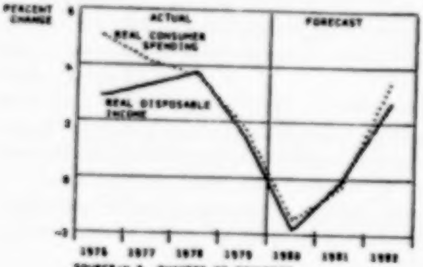
SOURCE: U.S. CHAMBER OF COMMERCE
FORECAST CENTER

As the economy continues to weaken, the unemployment rate is projected to continue rising this year and next, exceeding 9% by the end of 1980 and remaining high well into 1981. Although the rate of inflation, as measured by the consumer price index, is projected to abate during the remainder of 1980, it is still expected to remain within the double-digit range for the year as a whole.

The drop-off in consumption which precipitated the sharp GNP decline this year is not expected to show rapid recovery soon. The recent removal of credit controls will not overcome other factors holding down spending growth. The latest Chamber Survey of Consumer Attitudes shows a high degree of consumer pessimism. These worsened attitudes coupled with the continued deterioration in purchasing power and rising unemployment will retard recovery in consumer spending and GNP. Total consumer spending is forecast to decline throughout 1980 and recover only slowly in 1981.

Chart II

Changes in Real Consumer Spending and Real Disposable Income

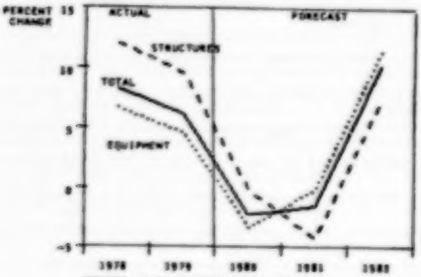


SOURCE: U.S. CHAMBER OF COMMERCE FORECAST CENTER

Personal income less personal taxes, adjusted for inflation, is a primary determinant of how much consumers spend. The forecast for real disposable income strongly suggests that consumer expenditures will fall in 1980 and early 1981.

Chart III

Changes in Real Business Fixed Investment



SOURCE: U.S. CHAMBER OF COMMERCE
FORECAST CENTER

The U.S. Chamber forecast anticipates a decline in real terms for business fixed investment in 1980 and 1981. Business fixed investment spending normally turns down after a recession begins.

Business fixed investment declined sharply in the second quarter and is expected to show a 2% decline for the year as a whole.

After adjusting for the effects of inflation on inventory valuation and inadequate capital consumption allowances, corporate after-tax profits are expected to decline about 25% in 1980 before recovering in 1981. Such low profit levels have probably acted as a brake on the expansion of investment in new plant and equipment in recent years--as discussed in a later section here--and dramatically point to the need for tax relief to stimulate savings and investment.

Comparison of Chamber and Administration Forecasts

The Chamber forecast anticipates a $65 billion federal deficit in fiscal 1981, assuming tax relief of $27 billion. This is larger than the $29.8 billion deficit in the July 21 "Mid-Session Review of the Federal Budget", in part because that contains no provision for tax relief, in part because we forecast a more severe recession and in part because the Mid-Session Review anticipates new revenue sources such as withholding on dividends and interest and a higher gas tax, which our forecast does not.

The Administration's current economic assumptions as specified in the Mid-Session Budget Review are still somewhat optimistic. However, they are much more realistic than the economic assumption behind the March, 1980 Federal Budget Revisions, and the assumptions provided to the Congress by the Congressional Budget Office for debate on the First Concurrent Resolution for fiscal 1981.

The short-range economic forecast underlying the Mid-Session Review's outlay and revenue estimates anticipates a 1980 year-over-year decline of -1.4% in real GNP compared to the U.S. Chamber's forecast of a -1.6% decline. The Review forecasts .3% growth in 1981 compared to the U.S. Chamber forecast of 1.3%.

IMPLICATIONS OF ECONOMIC CONDITIONS ON THE BUDGET ISSUE

The expansionist fiscal policies of the Federal Government have contributed to our economic problems. Protracted deficit spending increases tax and regulatory impediments to work, saving and investment. Accompanied by expansionary monetary policies of the Federal Reserve Board, it has resulted in the development of continuous, high inflation. At the same time, the growth of federal taxes and expenditures has tended to "crowd out" private business, as the public sector comprises an increasing share of GNP and the Treasury cuts into capital markets to finance the deficits.

With a deep recession in 1980-81, it has become increasingly clear that the federal budget for FY 1981 will not be balanced, regardless of what kinds of fiscal policies the Administration and the Congress adopt. As real GNP declines and unemployment rises, both corporate and personal tax receipts can be expected to fall off markedly, despite the tendency of inflation to increase tax liabilities.

Not only will the black ink remain elusive in FY 1981, but the attempts to balance the budget earlier this year have involved massive tax increases-- both legislated, and de facto tax increases stemming from inflation. The tax increases implicit in the fiscal 1981 budget will only intensify the recession by reducing disposable income and increasing the disincentives to work, save and invest. This will lead to higher unemployment. In turn, higher unemployment can only reduce receipts, vitiating the entire attempt at balancing the budget through higher taxes. At the same time, outlays anticipated in the First Concurrent Resolution for 1981 would comprise about 22% of GNP, one of the highest levels since World War II. In view of the present recession, this percentage is likely to increase to over 23%. Therefore, both spending levels and tax rates should be reduced and the process for limiting spending should be strengthened.

It was a mistake to attempt to balance the budget by such heavy dependence upon both legislated and unlegislated tax increases in the First Resolution. It is now very clear that for FY 1981 the recession will prevent a balanced budget in any case.

Therefore, other improvements in policy can be made which can be consistent with efforts to balance the budget over the business cycle. Clearly Congress needs to: 1) provide room for necessary tax relief in the Second Resolution, 2) continue the reconciliation process on the First Resolution, and consider making it a permanent improvement in the budget process, and 3) enact statutory spending limitations.

RECOMMENDATIONS FOR TAX RELIEF

Provision should be made in the Second Concurrent Resolution for fiscal year 1981 tax relief. In light of current economic conditions, the U.S. Chamber recommends that Congress move promptly to enact tax relief of $25 to $35 billion. This is warranted by the need to reverse the decline in productivity, to promote capital formation, to create jobs, to curb the unprecedented increase in the federal share of gross national product, and to improve our ability to compete for international markets.

Investment-oriented tax relief ought to be enacted in 1980 and made effective as quickly as possible. We cannot afford to delay measures to improve productivity and create a more favorable investment climate. Tax reductions which create jobs through increased investment add to industrial capacity, which will help moderate the economic downturn without increasing inflation. Any increases in the deficit resulting from tax changes would not be inflationary, so long as the Federal Reserve Board continues to restrain monetary growth.

Approximately half of the needed tax relief should promote capital formation. While about one-third of the tax reduction traditionally has been directed toward investment, the current pressing need to boost capital formation and productivity requires an increased commitment to this end, primarily through the adoption of the capital cost recovery system proposed in H.R. 4646 and S. 1435 and a reduction in corporate tax rates of at least two points. We are now suffering from a record low savings rate and a negative growth rate of productivity. Moreover, the nation's continuing large trade deficit requires the adoption of tax changes to remove existing impediments to exports.

The tax system should not restrict, but instead should encourage, the savings and investment necessary for national industrial growth, production, employment, and trade. Thus, changes in income tax provisions to encourage more savings and investment by individuals also are essential. These changes, designed to correct the existing heavy tax bias against investment, should include lowering the maximum tax rate on individuals from 70 to 50 percent, reducing the tax on capital gains, and providing tax deferred savings and investment accounts, dividend reinvestment plans, and more favorable treatment of retirement savings plans.

Tax relief for individuals in the form of across-the-board reductions in individual income tax rates also deserves high priority. This action is needed to ease the increased income tax burden on individuals caused by continuing high inflation. It should be accompanied by substantial additional cuts in spending to hold down the deficit and mitigate possible inflationary effects. According to the Mid-Session Review, in fiscal year 1981, individual income tax receipts are forecast to rise by more than $37 billion while overall, federal taxes will rise by at least $86 billion. This large transfer of income from private to public hands should be reversed by $25 to $35 billion in tax relief now.

Finally, the Chamber urges caution in the consideration of any changes in financing the social security system, based upon our overriding concern that the solvency of the system be maintained. The Chamber remains opposed to the use of general revenues to finance social security and cannot support reductions or offsets to social security taxes at this time.

Low Profits Suggest the Need to Provide for Tax Relief in the Second Resolution

Low real profits, low profitability relative to the risks, and uncertainty of business fixed investment, strengthen the case for tax relief now. Provision for this tax relief should be made in the revenue floor of the Second Resolution.

Rising corporate profits have been illusory. Inadequate rates of depreciation and inventory profits have not only erased those nominal gains, but have actually resulted in a significant decline in corporate profit once these costs of remaining in business are taken into consideration. As we sink deeper into the recession, adjustment for underdepreciation and inventory profits plus excessive taxation as indicated by a high effective tax rate, could together eliminate real profits. The effective tax rate has risen from 53.6% of adjusted profits in 1978 to 65.8% in the first quarter of 1980 (see Table 1).

Table 1

CORPORATE PROFITS FOR NON-FINANCIAL CORPORATIONS

	1978 (year)	1979 (year)	1980 Annual Rate (1st quarter)
Corporate profits with inventory valuation adjustment (IVA) and capital consumption adjustment (CCA) (billions $)	$128.3	$132.9	$125.9
Profits tax liability (billions $)	$ 68.8	$ 75.1	$ 82.9
Effective tax rate	53.6%	56.5%	65.8%
After tax profits adjusted for IVA and CCA	$ 59.5	$ 57.8	$ 43.0

Source: U. S. Department of Commerce, Bureau of Economic Analysis

As can be seen from Table 2 on comparable rates of return, the rate of return on depreciable assets has been running significantly below the rate of return one could get on risk free Treasury bills, and only marginally greater than one can get on tax free municipal bonds. While it is not the function of government to guarantee any return to investors, the decline in the return on capital has been a direct result of government policies. Existing policies have not allowed firms the faster depreciation necessary to recover replacement costs which have been increased by high inflation.

The inadequate rates of return on invested capital due to a punitive regulatory and tax system result in a shift in funds from risk-type investment in plant and equipment into safe havens of funds such as Treasury bills and investments in non-productive assets such as gold, collectibles and residential housing. The result has been a decline in productivity as the amount of invested capital and real income per worker has declined.

The inadequate level of profits is causing disinvestment in plant and equipment. Failure to alter the current regulatory and tax environment can only

Table 2

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
				COMPARATIVE RATES OF RETURN					
YEAR	Rate of Return on Depreciable Assets	After Tax Rate of Return Adjusted for IVA and Capital Consumption Allowance	U. S. Treasury Securities 10-Year Maturity	High Grade Municipals	Change in Consumer Price Index (All Items) (Year to Year)	After Tax Rate of Return Compared to 10-Year Treasuries	After Tax Rate of Return Compared to High Grade Municipals Col.(3)/Col.(5)	After Tax Rate of Return Adjusted for CPI Col.(3)-Col.(6)	Common Stock Yields (percent)
1955	14.4	6.2	2.82	2.53	-.4	2.20	2.45	6.6	4.08
1956	12.4	5.5	3.18	2.93	1.5	1.72	1.88	4.0	4.09
1957	11.2	5.0	3.65	3.60	3.6	1.37	1.39	1.4	4.35
1958	9.5	3.9	3.32	3.56	2.7	1.17	1.10	1.2	3.97
1959	12.1	4.9	4.33	3.95	.8	1.13	1.24	4.1	3.23
1960	11.2	5.0	4.12	3.73	1.6	1.21	1.34	3.4	3.47
1961	11.0	4.5	3.88	3.46	1.0	1.16	1.30	3.5	2.98
1962	12.7	5.9	3.95	3.18	1.1	1.49	1.85	4.8	3.37
1963	13.6	6.4	4.00	3.23	1.2	1.60	1.98	5.2	3.17
1964	14.6	7.6	4.19	3.22	1.3	1.81	2.36	6.3	3.01
1965	15.8	9.3	4.28	3.27	1.7	2.17	2.84	7.6	3.00
1966	15.7	9.1	4.92	3.82	2.9	1.85	2.38	6.2	3.40
1967	13.8	8.0	5.07	3.98	2.9	1.58	2.01	5.1	3.20
1968	13.6	7.8	5.65	4.51	4.2	1.38	1.72	3.6	3.07
1969	11.9	7.1	6.67	5.81	5.4	1.06	1.22	1.7	3.24
1970	9.4	4.6	7.35	6.51	5.9	.63	.71	-1.3	3.83
1971	9.7	5.4	6.16	5.70	4.3	.88	.95	1.1	3.14
1972	10.7	6.6	6.21	5.27	3.3	1.06	1.25	3.3	2.84
1973	10.3	9.2	6.84	5.18	6.2	1.35	1.78	3.0	3.06
1974	7.8	8.8	7.56	6.09	11.0	1.16	1.44	-2.2	4.47
1975	8.3	5.4	7.99	6.89	9.1	.68	.78	-3.7	4.31
1976	9.3	4.8	7.61	6.49	5.8	.63	.74	-1.0	3.77
1977	9.7	6.3	7.42	5.56	6.5	.85	1.13	-.2	4.62
1978	9.7	7.1	8.41	5.90	7.7	.84	1.20	-.6	5.28
1979	9.2	7.7	9.44	6.39	11.3	.82	1.20	-3.6	5.45

Source: Economic Policy Division, Chamber of Commerce of the United States.

lead to further calls for such assistance from other sectors and no quick economic recovery in the traditional sense.

RECONCILIATION IN THE FIRST CONCURRENT RESOLUTION

The U.S. Chamber supported a smaller level of fiscal 1981 outlays than the $613.6 billion in the First Concurrent Resolution Conference Report of June 12, 1980. However, we do recognize that the First Resolution reconciliation process passed unanimously by the Senate (The Reconciliation Act of 1980, S. 2885) and the First Resolution reconciliation process pertaining to eight House Committees, both improve the budget process for the fiscal 1981 year. They should be considered as a permanent measure to better control federal spending in future years also. It is our understanding that the reconciliation process included in the fiscal 1981 First Resolution is discretionary, and may not be included in future years when there will be less apparent public support for fiscal restraint. Thus, an important potential source of greater budget discipline and restraint could be lost. We recommend that, before a decision is made, Congress study carefully the opportunity to include First Resolution reconciliation of targeted spending levels in the budget process permanently.

Greater legislative savings could also be obtained where authorizing committees make permanent program cuts as opposed to savings applying only to the upcoming fiscal year--cuts which could be more than fully restored in subsequent years and might be illusory when outlays are averaged over two or three fiscal years. If the reconciliation provisions and bills for fiscal 1981 are not to be permanent, and the program savings they have engendered are also not permanent, then the lost opportunities for restraint on spending growth in future years are compounded. However, no procedure by itself can limit the growth of federal outlays in future years.

The federal deficit for fiscal 1980 was estimated to be $47 billion in the First Resolution. In fact, it may exceed $60 billion. Measures to further discipline the spending process are necessary. Reconciliation is such a measure.

SPENDING LIMITATION LEGISLATION IS NEEDED

The Chamber forecasts that in fiscal 1981 outlays will exceed 23% of GNP. While this results in part from the recession, it is a record level in the post-war period. Specifically, the U.S. Chamber supports a strict limit on direct federal spending as a percent of GNP. We have previously recommended that this be set at 21% of GNP in fiscal 1981 and 20% thereafter. So-called "tax expenditures" should not be part of a spending limitation, because they have different impacts and characteristics from direct spending.

Congress should be alert to the upward creep of planned outlays caused by such factors as supplemental appropriations, entitlement underestimates, interest rate changes and changing economic assumptions. In January 1979, the fiscal 1980 budget anticipated outlays of $532 billion. The Mid-Session Review of July 21, 1980 estimated fiscal 1980 outlays at $578.8 billion--a total increase of $46.8 billion. The Administration expects fiscal 1981 outlays to be $633.8 billion, up from $613.6 billion in planned outlays in the June 12, 1980 Congressional Conference report.

CONCLUSION

In summary, we have concluded that deteriorating economic conditions, both as a result of a downturn in the business cycle and a longer term element of weakness, call for decisive policy action. This should include: 1) immediate enactment of tax relief which would reduce the disincentives to work, save and invest, 2) enactment of the reconciliation bills and 3) enactment of spending limitation legislation.

INDEX

Budget: Page
- Accelerated spend-out rates ... 170
- Act, amend for better control over Government spending ... 131
- Administration's proposal for tax cut unchanged ... 181
- Agricultural commodity embargo, increased revenues from rescinding ... 183
- Anti-inflationary fiscal policies ... 28
- Balance:
  - Abandon objectives for 1981 ... 37
  - Continue efforts to ... 188
  - Cut spending and maintain ... 213
  - Cuts stemmed from demand for ... 38
  - Different approach needed for ... 40
  - Fiscal policy and ... 14, 23
  - Government inability to ... 9
  - Impact of tax cut on obtaining ... 194
  - Insure near-term ... 196
  - Move toward ... 32
  - Not possible for 1981 ... 38
  - Tax changes consistent with efforts to ... 120
  - Unlikely for 1981–83 ... 179
  - Windows of opportunity for ... 119
- Business tax cuts ... 10
- CBO and OMB pay assumptions ... 199
- Committee, disparities in economic projections threaten credibility of ... 130
- Committee, examine all Federal activities at once ... 142
- Congressional action consistent with President's policy ... 160
- Credibility of process threatened by inaccurate forecasts ... 167

Budget—Continued Page
- Deficit:
  - Elimination of tax cut would not erase ... 29
  - Financed through Federal Reserve ... 43
  - Increased outlays/reduced revenues increase ... 5
  - Inflation caused by ... 138
  - Major tax reductions for 1981 would increase ... 2
  - No connection between inflation and ... 41
  - Not a result of new authorizations ... 83
  - Resources for investment, increase share of ... 15
  - Resulted from recession and slow growth ... 62
  - Tax cut, impact on ... 15
  - Tax cuts, would increase ... 180
- Dual effect of restrictive ... 114
- Economic projections not infallible ... 240
- EDA programs, additional funding for ... 186
- Entitlement programs ... 95
  - Encumbered by poor estimating procedures ... 96
  - Percentage of claimants to percentage of those qualified rising ... 95
- Eroded by unpredictable circumstances ... 212
- Expenditures, feasibility of placing binding ceiling on ... 82
- Expenditures to offset effect of grain embargo ... 183
- Federal expenditures, controlling ... 94

Budget—Continued

Page

- First Concurrent Resolution, analysis of 212
- Fiscal and monetary policy 23
- Fiscal policy 27
  - Alter current restrictive 33
  - Current 107
  - Deep recession possible response to restrictive 34
  - Eroded by uncontrollable expenditures 117
  - Increased long-term restraint necessary 158
  - No reason for Congress to alter 32
  - Options 107
  - Pressure increasing for more stimulative 251
  - Stimulative, currently unnecessary 252
  - Stimulative, inflationary result of 253
- Fiscal procedures, expenditure growth necessitates change in 72
- GNP, impact of off-budget programs on 98
- Inflationary nature of tax cuts 45
- Mid-Session Review estimates 160
- Military pay comparability, increase projected for 199
- Military pay increases, cost of 171
- Military personnel, pay increase for 170
- Monetary policy 10
- Money bills, require super-majority vote for 73
- Off-budget items 97
- Outlays for synfuel mandate not reflected in 201
- Outlook 106
- Problems, automatic add-ons compound 72
- Process:
  - Alive and well 62
  - Major instrument in reconciling economic goals 211
  - Need for credit budget in 97
  - Utilize flexibility of 91
- Public confidence in Congress or administration waning 181
- Public works program, administration's support for accelerated 185
- Public works programs, $100 billion approved but unused in 198
- Receipts:
  - Declining 161

Budget—Continued

Page

- Receipts—Continued
  - Reduced, over half of deficit increase due to 162
  - Shortfall expected, reasons for 127
  - 10-5-3 tax program, impact on 129
- Resolution:
  - Does not make tax cuts 176
  - Include administration's recommendation for tax cuts in 175
  - Provisions, Fed suggestions for 237
- Restrained monetary policy, results of 239
- Restrictive policy, continue 108
- Revenues:
  - Assessing increased Federal 74
  - Gasoline tax calculated in 167
  - Grain embargo, resulted in lost 183
- Second Resolution, unanticipated items not in 163
- Shifts, explanation of quick 167
- Small adjustments to existing programs, net effect of 83
- Specifics for tax cut, administration not ready to recommend 175
- Spending decisions, justification for increased 163
- Spending, economic conditions that suddenly increase 168
- Spending increases 108
- Spending restraint:
  - Congress successful in 182
  - Continue 7, 47, 162, 196
  - Re-establish by constitutional amendment 96
- Tax burdens, maintain at current levels 195
- Tax cuts 23, 213
  - Business investment 243
  - Careful deliberation necessary in discussing 30
  - Conditions for 237
  - Conservative approach best 64
  - Dollar-for-dollar spending cuts 238
  - For the 1980's 9
  - 1981—year for 235
  - Not advisable at this time 234
  - Out-year revenue losses from small 235
  - Phased-in 242
  - Pre-election, unwise 214
  - Structure 63
  - Target programs for 69, 234
  - The compelling case for 63, 68

Budget—Continued Page

- Tax cuts—Continued
  - Time frame projection for 29
  - Unstable economic conditions preclude major 231
  - Would lead to higher interest rates and inflation 241
- Tax increase, windfall profits tax setasides prevent 75
- Tax options 108
  - Administration's "no policy change" position unsatisfactory 146
  - Business sector cuts alone unacceptable 197
  - Business tax cuts 110
    - Corporate tax rate 112
    - Increase investment tax credit 112
    - Jorgenson first-year plan 111
    - The 10–5–3 plan 110
    - Ullman depreciation plan 111
  - Cut package, extend over 5-year period 205
  - Cuts for 1981 to encourage economic recovery 187
  - Cut taxes for savings and investment 16
  - Deficit, tax cut would increase 177
  - Develop 10-year tax plan 35
  - Gross tax cut 92
  - Inflationary aspect of changes 123
  - Investment incentives to business sector 197
  - Kemp-Roth across-the-board 52
  - Long-term consequences of tax cut, assess 174
  - Necessity for tax cut in 1981 176
  - Payroll tax increases for social security, delay 113
  - Personal tax cuts 108
    - Across-the-board reduction in .. 110
    - Bracket creep, impact of rate structure on 118
    - Credit against social security taxes 109
    - Inflation-offsetting 110
  - Productivity oriented tax cut 205
  - Provide tax relief to individuals .. 197
  - Push for tax cut, politically motivated 179
  - Quickie election year tax cut 172
  - Reductions, rationale for 179
  - Social security payroll tax reduction 252

Budget—Continued Page

- Tax options—Continued
  - Social security tax credit 172
  - Supply side tax cuts 159
  - Tax credit invites general revenues into social security 173
  - Tax cut in 1981, aspects of 159
  - Tax package concerns administration 173
  - Trade-offs involved in 112
- Tax policy for coming year, administration should supply now 177
- Third Concurrent Resolution on revenue side likely for 1981 177
- Unbalanced by unexpected deep recession 1
- Unspent balances in Federal programs with major public works components 139
  - Community development block grants 140
  - EPA construction grants 140
  - Federal-aid highways 140
  - Tennessee Valley Authority 141
  - Urban Mass Transportation Administration 140
- Work programs, no way to speed up 198
- Year-end wasteful spending by Federal agencies 186

Defense:

- Inflationary nature of expenditures for 36
- Spending 18

Economy:

- Administration's forecast 151
- Assumptions 161, 162
- Auto industry:
  - Federal regulations created false signals for 90
  - Swayed by big car profits 90
- Avoid overcorrecting 241
- Bottom of downturn by end of year ... 94
- Bracket creep, only affects pay increase recipients 74
- Budget balance through increased taxes would stifle productive system 71
- Business investment 18
- Capital formation, Congress more sympathetic to needs of industry for 87
- Capital spending 13, 18

Economy—Continued Page
CBO:
Estimates not infallible 33
July assumptions reflect dramatic drop in 134
Projections for 1980–81 233
Changes that increased spending 169
Congress cannot control 189
Consumer circumstances improved 254
Consumer spending:
Credit controls and rising interest rates, impact on 116
Decreased, impact on inflation 136
Delay in resumption of questioned 116
Expectation of continued inflation spurs 126
Unabated 117
Could recession have been avoided or moderated? 44
Course of 57, 65
Cut taxes or reduce expenditures first 85
Decline in moderating 149
Deregulation, concept of questionable 245
Developments of the 1970's 153
Employment, percent change in total 152
Entering steep recession 149
Failing industries, major 132
Farm price supports, administration moving toward raising 183
Federal Reserve:
Current economic crisis, role of 133
Policy, aimed at restoring confidence in the dollar 137
Policy, assessment of 130
Recession created by 135
Fiscal drag, impact not reflected in GNP 195
Fiscal restraint, continue policy of 103
Forecasting credibility clouded by record of inaccuracy 7
Forecasts for 1980–81 26
GNP, Federal spending exceeds growth of 15
GNP, real growth of 58, 65, 94
Government inspired borrowing, businessmen in competition with 143
Growth in money and credit, reduce gradually 231
High cost of fighting inflation by monetary fiscal restriction 60
Housing starts 13, 18

Economy—Continued Page
Increased Federal spending 161
Industrial growth, review areas where Federal policy inhibited 89
Industrial production, growth of 152
Industrializing steel complex, 10–5–3 the answer to 200
Interest rates for 1981 250
Interest rates, impact of Budget restraint on 248
Inventory investment 19
Legacies of the past decade 147
Long-term interest rates, direction of in doubt 247
Long-run recovery program 151
Lower real estate prices precluded by demographic structure of 127
Lower receipts expected due to pessimistic outlook of 128
Mid-year outlooks, areas of disagreement with 93
Monetary policy, impact of changing 116
Monetary rate for 1981 249
Money bills, require super-majority vote for 92
Money supply, annual growth rate target for 11
Money supply, use of reserve growth to fine tune 11
Monitoring managers, efforts of Congress undone by 189
Mortgage market funds, DIDC action taken to help 244
Mortgage market, long-term money provides basic assurance to 245
Mortgage rates, cash flows continue to support lower 247
Mortgage rates, Depository Institutions Deregulation Committee action would increase 244
OPEC price increases main cause of slowdown in 165
Outlook for 1980–81 12, 16
Outlook, short-term 155
Output gaps and costs 59, 66
Personal savings rate 19
Problem sectors 48
Auto industry 48
Capital investment for failing industries, insure 121
Depreciation allowances and tax system, streamline 50
Federal regulations, impact on 51

Economy—Continued Page
  Problem sectors—Continued
    Industrial disasters, policy to head off 81
    Investment inducements or bail out faltering companies 51
    Modernize archaic industries 49
    Research on industry-by-industry basis 49
    Revitalization, create Federal agency for 50
    Steel industry 49
    Target tax incentives to failing industries 89
    Tax cut for 51
    United Kingdom assistance to inadequate industries regretted 80
    Weakening industries, Federal assistance to 79
  Productivity, impact of percent change in total employment on 184
  Productivity, industry restructured to improve 182
  Real estate prices, precipitous drop for? 127
  Recent developments in 104
  Recovery 93
    Factors for 253
    Program, develop long-run 156
    Sooner than predicted by forecasters 3
    Viewed pessimistically by financial community 250
  Relationship between size of deficits and inflation 42
  Savings deposits, increased 246
  Short-range measures, must coincide with long-term policy 242
  Short-run stimulus inadequate 152, 157
  Short-term outlook 150
    Business inventory low 150
    Interest rates declining 150
    Real purchasing power eroded 150
  Slowdown, monetary policy immediate cause of 165
  Stabilize 118
  Stimulated, could cause higher inflation and consequent recession 115
  Stimulus, Congress beset with proposals for 146
  Stronger and unemployment lower than projected 146
  Supply and structural policies 158

Economy—Continued Page
  Upturn seen for credit-sensitive sectors of 17
  Tax burden, bracket creep increases real 71
  Tax changes to increase productivity and capital investment 122
  Tax cuts, deteriorating conditions strengthen case for 124
  Tax cuts, estimating reflows from 124
  Tax cuts, Mid-Year Review excludes 174
  Tax system, encourages consumers to invest primarily in housing 121
  10-5-3 plan, provides uneven tax benefits to different industries 200
  Transfer payments on unemployment and recession, impact of controls on 45
  U.S. industries, assessing the well-being of 206
  U.S. per capita productivity lagging 88
  Upturn, evidence of 135
  Vigorous recovery projected for 1982 17
  Wage and price controls, mandatory 70
  Wage and price performance, gear tax system to 42
  Wage and price restraint 53
    Penalties and rewards for 54
    Tax reductions for 54
  Weak recovery projected for 1981 114
Inflation 14, 19
  All tax cuts would not be inflationary in 1981 123
  Annual rate projected for 1981-83 125
  Average rate for fiscal year 1981-83 178
  Causes and cures 40, 52
  CPI estimate of average rate of 178
  CPI projections, interest rates vary 47
  Cost-of-living, consumer wage adjustments falling behind 254
  Credit demands and behavior affected by expectations for 210
  Declining productivity:
    Driving up 180
    Underlying cause of 35
  Economic growth sacrificed in effort to retard 58
  Energy prices 22

Inflation—Continued — Page
- Federal debt and budget deficits, impact on 133
- Federal spending increased by 87
- Food prices 22
- Housing prices 22
- Institute wage and price controls to combat 55
- Loan guarantees, effect on 143
- Long-term problems, assess effect of short-run action on 211
- Massive tax cuts could escalate 134
- Monetary and fiscal policies, controlling the growth of demand through 158
- Monetary policy alone insufficient to deal with 248
- Monetary remedies could increase 78
- Monetary shocks incompatible with long-term stability 4
- Off-budget items, effect on 142
- Offsetting tax cuts 110
- Over-corrected economy would raise interest rates and increase 166
- Outlook 60, 67
- Pace slowed significantly 148
- Rate for next 3 years to average 8 percent 125
- Response of Federal Reserve to 210
- Rising, oil company profits and OPEC price increases share blame for 255
- Roles of Congress and Fed overlap in war on 34
- Spending programs, impact on 132
- Tax brackets, inflation pushing individuals into higher 180
- Tax cut or spending increases would add to 137, 180
- Use of monetary shocks to stem 3
- Wage and price increases 61

Recession:
- Auto bust, production incentive not cause of 258
- CBO forecast 105
- Current, produced by change in monetary policy 77
- Deeper than projected 93, 167
- Economic drags that led to 78
- Economy entering steep 154
- Federal Reserve policy exacerbated 257
- High interest rates, effect on 165

Recession—Continued — Page
- Inevitable, forces that made 58, 65
- Length and depth of 150, 155
- Major increases in capital spending, effect on 86
- Not as deep as projected 190
- Recovery periods, comparing 31
- Result of administration's policy 164
- Role of credit guarantee programs in current 77
- Seen ending soon 191
- Shorter than projected by CBO 102

Unemployment 13, 17
- CBO forecast questionable 103
- Changes in CBO forecasts on 134
- Congress right, business wrong 260
- Congressional action to curb 55
- Desperate plight of 255
- Fiscal and monetary policy, use to combat 84
- High, projection for questioned 102
- Higher than projected 93
- Immediate relief necessary for 256
- Insurance, inflationary impact of increased 36
- Job programs, utilize to combat 76
- Long-term cure only answer for 256
- Long-term headache from short-term fix 236
- Lower and economy stronger than projected 146
- Major spending increase or tax cut not the answer to 30
- Modernized industries may require fewer employees 84
- No immediate action feasible 31
- No short-term solution for 31, 115
- Pre-election stimulus for 76
- Present policy provides no hope for 258
- Projected rate of 129, 240
- Quick fix for 233
- Quick fix has bad record 257
- Rate, impact on voters 166
- Rate, pre-election cure for 171
- Retroactive tax cut package, impact on 55
- Rising, no short-run cure for 138
- Seasonal fluctuation of 182
- Short-term action to ameliorate 30, 236
- Tax cut a possible remedy for 240
- Tax cut, size necessary to reduce 137